LOCAL TAXATION AND INFORMAL ECONOMIES

EDITED BY

Nick Devas

OPEN SOCIETY
FOUNDATIONS

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LGI POLICY FELLOWSHIP PROGRAM

LGI's fellowship program supports practical policy reform in the region, builds the capacities of talented individuals who are well placed to influence policy, creates networks of multinational experts, and supports the mission of LGI. Each year LGI selects talented professionals from Central, East, and South Eastern Europe and the former Soviet Union to participate in the one-year program. Fellows work in small teams under the guidance of a well-respected mentor to produce policy-oriented studies on a given topic. The completed studies are impact oriented; each contains an advocacy or implementation strategy and concrete policy recommendations. LGI provides its fellows with training on how to write effective, concise, fact-based, practical policy reports. Other training modules LGI offers its fellows are public speaking, presentation skills and advocacy methods. At the conclusion of the program LGI works with its fellows to determine what steps it can take to support the proposed recommendations in the completed studies. Fellows are generally policy researchers, policy advisers, civil servants and members of NGOs, advocacy groups, or professional associations.

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Saad Paracha works as a senior programs officer for the Asian Development Bank (ADB) in Pakistan. He provides technical expertise and operational support for country programming work and participates in policy dialogue with federal and provincial governments on strategic issues and the overall portfolio. He has designed and managed projects focusing on public sector reform including public financial management, local governance and allied governance, and service delivery aspects. Before joining the ADB, in his role of governance specialist with the USAID Pakistan, he was involved in developing and managing programming for improving the ability of local governments to deliver critical services to their constituents, strengthening the role of national and provincial parliaments, improving civil-military relations, reforming electoral processes and political parties, and addressing the particular human rights issues faced by women in his country. Prior to this Saad worked in various capacities with the government of Pakistan on policy formulation and their implementation in the areas of development cooperation, external resource mobilization and program management in social and governance sectors. He has been selected as a Chevening Fellow by United Kingdom's Foreign and Commonwealth Office, an International Policy Fellow by the Open Society Institute, and a Summer Democracy and Development Fellow by Stanford University. He holds an MA in Public Administration from Pakistan and a post-graduate diploma in Development Studies from Japan. He was the lead researcher that supported the background work for this publication.

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Edi Suharto, PhD, is a specialist in the area of social work macro practice and is currently vice chairperson for Academic Affairs at the Bandung College of Social Welfare, Indonesia after serving two years as director of the Postgraduate School of Specialist Social Work at the college. He is also a visiting lecturer at number of interdisciplinary and postgraduate programs in social work across Indonesia dealing with topics like social policy, social welfare services, poverty alleviation programs, social protection and social security schemes, and child protection as well as corporate social responsibility and community development initiatives. In the last decade, he has consulted for a range of international organizations such as ILO-IPEC (International Labour Organisation – International Programme for the Elimination of Child Labour), Center for Policy Studies (CPS), Hungary; Galway Development Services International (GDSI), Ireland; the Ministry of Social Affairs in Indonesia to develop a conditional cash transfer scheme; Plan International; UNICEF to analyze the referral systems of child protection in Indonesia, and other assignments. Edi has published more than twenty titles, chapters, and articles in a number of international and national journals.

Adams Tandorswefa Tommy is currently studying for an MA in Comparative Local Development under the scheme of the Erasmus Mundus program. He has two previous degrees in economics and is a senior economist in the Intergovernmental Fiscal Affairs and Local Government Finance Department of the Ministry of Finance and Economic Development in Sierra Leone. His specialized fields are public finance with specific reference to fiscal decentralization. He has authored many papers that await formal publication that include: how inequality affects the development of localities in Sierra Leone; a critical analysis of the conceptual and methodological aspects of social capital and its role in local development. He is currently working on a thesis on the role of subnational governments in achieving the Millennium Development Goals (MDGs), with Sierra Leone as a case study. He is originally from Kono District, Eastern Province.

Mosharraf Zaidi has served as a member of staff and advisor to governments, international organizations, bilateral donors, political campaigns, and nongovernmental organizations for nearly fifteen years. As a public policy resource for organizations and leaders, *Mosharraf* has helped formulate a breadth of policies, laws, and positions on fundamental change processes across institutions, agencies, and organizations. He has helped manage and negotiate change in complex environments, constrained by both financial and human resources—both among and within international and developing country bureaucracies. His public policy work has included research and analysis on a range of governance issues, both structural and substantive. He has contributed to the policy discourse in areas such as education, emergency relief and reconstruction, telecommunications, technology, civil society, and citizen empowerment. His most recent assignments have required him to focus on decentralization and local governments, public sector capacity, project and program impact measurement (M&E), counter-radicalization, state-building, elections, access to justice, and civil service reform. *Mosharraf* writes a weekly column for *The News* in Pakistan. His articles also appear a variety of publications including *Al-Shorouk* in Egypt (in Arabic), *The Nation, The Times of India, The Mumbai Mirror, The National*, and *The Wall Street Journal*. He is a frequent contributor to television and radio, including CNN, Al-Jazeera, National Public Radio, Geo News, and Dunya TV.

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Introduction: Local Taxation of Informal Economies

Nick Devas

THE PROBLEM AND THE RESEARCH

Local governments around the world are almost invariably short of money. As a consequence, most local governments are unable to provide adequately the local services that are needed by local citizens—services that are crucial for poverty reduction and economic development. This situation arises for many reasons: the mismatch between the functions assigned to local governments and the revenue sources assigned to them (the problem of vertical imbalance); the widely differing levels of financial resources between local governments (the problem of horizontal imbalance); inadequate or unpredictable transfers from central or state governments; weak revenue collection performance by local government; and poor expenditure management by local government. In most countries, it is a combination of all of these. But among these, the inadequacy of local revenue instruments is often a key issue, whether in developed, developing, or transitional countries. This problem is exacerbated in many developing and transitional countries because the local economy, on which local governments depend for their local revenues, is largely "informal" and therefore hard to tax.

This research project, under the LGI Fellowship scheme, was designed to identify whether and how local governments in developing and transitional countries can generate resources effectively, efficiently, and equitably from their local economies when those economies are to a large extent informal. Studies were conducted during 2008–09 by local researchers in six countries: Georgia, Ukraine, India, Pakistan, Indonesia, and Sierra Leone.

MOBILIZING LOCAL REVENUES

The extent to which local governments can finance their expenditures out of local taxation varies enormously both among and within countries—see Tables 1 and 2.[1] In some OECD countries, local governments may be able to generate a large proportion of their budgets from local taxes and other local revenue sources.[2] In developing and transitional countries, the proportion may be much lower, whether because of inadequate local tax instruments or the relative importance of tax sharing (particularly in transition countries). The variations within countries may also be enormous, with capital cities potentially being self-sufficient, given the appropriate local tax instruments, while remote rural areas have little or no local revenue possibilities. Nor should financial self-sufficiency necessarily be regarded as a satisfactory situation, since it may simply mean that local services are provided inadequately or not at all.[3]

Table 1.
Local Revenue Sources: Selected European Countries

2007 (provisional data)	**UK**	**Germany**	**France**	**Italy**	**Spain**
EUR billions, except for the UK in GBP billions	**LG**	**SG+LG**	**LG**	**LG**	**LG**
Local Taxes Income and profits		179.4		22.4	32.2
Payroll			6.8		
Property	23.6	20.7	68.5	12.2	31.4
Goods and services		93.5	17.7	66.5	53.3
Subtotal: Local taxes	23.6	293.6	93.0	101.1	116.9
Social security contributions	3.4	17.8	0.5	1.2	0.8
Other local revenue	23.8	59.5	53.3	26.8	15.7
Subtotal: Local Own Revenue (LOR)	50.8	370.9	146.8	129.1	133.4
Grants/transfers	124.0	109.9	58.1	103.3	85.2
Total Local Government Revenue	174.8	480.8	204.9	232.4	218.6
Total General Government Revenue*	584.3	1,064.7	940.4	716.2	431.1
Local Taxes as Percent of Total Local Government Revenue	13.5%	61.1%	45.4%	43.5%	53.5%
LOR as Percent of Total Local Government Revenue	29.1%	77.1%	71.6%	55.6%	61.0%
LOR as Percent of Total General Government Revenue	8.7%	34.8%	15.6%	18.0%	30.9%

Notes: * Total for all levels of government net of transfers.
LG: Local Government.
LOR: Local Government Own Revenue.
SG: State or Province Government.

Source: IMF Government Finance Statistics 2008.

Much depends on the local tax instruments available. Property tax remains the most common form of local tax around the world. There are good reasons for this, not least the ease by which the revenue can be assigned to the right jurisdiction, and the widely accepted connection between the services provided by local government and the value of the property being taxed. But property tax has serious weaknesses, not least the visibility of payment (unlike income tax which can be collected at source, or VAT which is disguised in the final price of a purchase). This visibility makes the tax highly-sensitive politically, which in turn makes for a reluctance to raise the tax rate, revalue property, and update tax registers. Without such actions, revenues from property tax are eroded by inflation and fail to keep up with population and economic growth. In addition, in many transition countries, there is still not yet a fully developed property market on which to base valuations, so that property taxes are often levied on the even more inelastic base of property size. Moreover, in some cases, as in Georgia, the scale of exemptions is such as to render the tax almost insignificant. Meanwhile, in many developing countries, property tax is often still confined to the urban core (and in some cases just to the old colonial core), thereby not capturing the vast peri-urban growth, never mind the property (not all of which is rudimentary) in rural areas.

Table 2.

Local Revenues in Selected Case Study Countries

	Georgia	Ukraine	India		Indonesia	Sierra Leone
	LG 2008	LG 2008	Urban LG 2002/3	All LG*** 2002/3	SG+LG 2005	LG 2008
	GEL million	UAH million	Rupees ten million	Rupees ten million	Rupiahl trillion	Bn Leones
Local Taxes * Income and profits						
Poll tax						1.43
Property	120.7					1.59
Goods and services	55.7	820				
Subtotal: Local taxes	176.4	820	4,941	5,870	3.91	3.02
Other local revenue	218.9	14,579	2,419	3,134	6.15	5.29
Subtotal: Local Own Revenue (LOR)	395.3	15,399	7,360	9,004	10.06	8.31
Grants/transfers	793.3	122,865	5,236	27,603	110.53	56.80
Total Local Government Revenue	1,188.6	138,263	12,596	36,607	120.59	65.11
Total General Government Revenue**	4,827.6	297,845				1,069.21
Local Taxes as Percent of Total Local Government Revenue	14.8%	0.6%	39.2%	16.0%	3.2%	4.6%
LOR as Percent of Total Local Government Revenue	33.3%	11.1%	58.4%	24.6%	8.3%	12.8%
LOR as Percent of Total General Govt Revenue	8.2%	5.2%				0.8%

Notes: * Shared taxes included under transfers not under local taxes.
** Total for all levels of government net of transfers
*** India: All LGs = Urban Local Bodies plus all Panchyati Raj Institutions (rural).
LG: Local Government
SG: State or Province Government.

Source: Case studies in this volume.

Some countries allow local governments to tax a variety of other objects, such a motor vehicles, tourism and entertainment, electricity consumption, land development, and so on. These all have some very positive characteristics as local revenue sources, not least that they are relatively easy to administer. Yet central governments are often reluctant to surrender such revenue sources to local government.

Then there is a range of taxes on the local economy that can be found in different countries: taxes on sales or turnover or profits, whether levied on the local economy as a whole, or on certain sections of it. Such taxes present significant problems, in terms of overlap with national taxes, how to assign the revenues to the right local governments, and how to assess businesses' ability to pay effectively and fairly.

However, what is apparent is that, in many developing and transitional countries, local governments have a variety of revenue instruments that impinge on the local economy even though they may not technically be taxes. Levies such as charges for markets (a major revenue source for local governments in many African countries), business licenses, permits for street trading, etc., are not technically taxes but are rather charges for a service provided, or a fee for a permit or license to carry out an activity. However, inasmuch as the revenue generated greatly exceeds the cost of the service or benefit provided, or of the regulatory function involved, these revenue sources are effectively taxes on the users of the services. Thus, the conventional distinction between taxes and nontax revenues is unhelpful for our purposes. What we are concerned with here is the range of local revenue instruments, whether tax or nontax, that impinge on, and generate revenue from, the local economy.

There may also be a variety of other nontax instruments that impact the local economy: charges for water supply, sanitation and waste disposal, fees for building permits, tolls levied on local roads, etc. In most cases, such levies at best merely recover the costs of the services or regulatory functions being provided. But to the extent that any of these generate revenues from the local economy, or place burdens on the local economy that exceed the value of the service being provided or the regulatory function involved, such revenue sources are relevant to our study.

LOCAL TAXATION AND THE INFORMAL SECTOR

Thus, what we are concerned with here is the range of local revenue instruments, both tax and nontax, that do, or could, generate net revenues from the local economy in some way or other. The particular challenge addressed in this research is how to generate such resources in situations where large parts of the local economies are effectively informal. The phenomenon of the informal sector is well known and widely documented in developing countries, particularly in urban areas. But it has also been an increasing feature of the transitional countries in Central and Eastern Europe and the former Soviet

Union, as state enterprises have collapsed and newly-privatized enterprises have shed surplus labor. Indeed, it can be argued that an extensive informal sector existed under communism, but that it was largely hidden and therefore unrecognized. The situation has become a great deal more severe as a result of the structural adjustments that have taken place in these economies in the last two decades.

It is not the intention in this volume to try to define precisely the informal sector, or to spend time discussing the nature of that sector: there is already a huge and growing literature on the subject (for example: Guha-Khasnobis, Kanbur, and Ostrom 2006; Pratap and Qunintin 2006; Yuki 2007). But it is necessary to clarify what we mean by the informal sector for the purposes of this research. Essentially we are talking about activities that are in some way or other not fully compliant with state regulations and so operate at the margins of the economy. They may range, at one end of the spectrum, from street vendors hawking their wares in locations where officially they are prohibited, to quite large businesses that do not have the necessary permits to operate, do not confirm to various regulations, and/or are evading taxation. It may even include certain activities of formal sector businesses that are set up in ways to avoid regulatory or tax requirements. It may include criminal, or at least illegal, activities. All of these things make taxing such activities more—even more—difficult. But it does not mean that it is impossible to generate revenues from such activities: with a suitable range of instruments, and with political will and administrative capacity, there is the potential to generate significant revenues from informal sector activities.[4]

Nor is it the case that the informal sector is always poor, in such that any attempt to generate revenues from it is burdening the poor. As the Indonesian case shows, many street traders can earn incomes comparable to those in the formal sector. Indeed, some parts of the informal sector may actually generate substantial incomes for those involved, albeit often through the exploitation of unprotected workers. The evasion of regulation and taxation can give such enterprises substantial advantages over formal sector businesses. It is therefore equitable that revenue instruments should be applied and enforced on such enterprises. However, some parts of the informal sector are undoubtedly poor —street vendors and shoeshine boys, for example. It is not the intention of this research to identify ways in which heavier tax burdens can be imposed on such people. Indeed, one of the conclusions from the research is that low-income informal sector activities are often burdened by various levies that are unofficial or illegal, the revenues of which are unaccounted for.

EVALUATING LOCAL REVENUE MOBILIZATION

The aim of this research was to examine the ways in which local governments in developing and transitional countries do, or could, generate revenues from their local economies when those local economies tend to be informal. However, it is not enough just to look at how much revenue is collected. There are a number of considerations for evaluating the performance of local revenues.

First, there is the absolute amount that is generated from a particular revenue source, including the share of the local budget and the amount per capita. Regrettably, many of the local revenue sources identified in the case studies generated microscopic amounts of money.

Second, there are the trends in revenue collection over time, and particularly whether revenues grow in real terms (adjusting for inflation), in per capita terms (adjusting for population growth), and in relation to economic growth (comparison with GDP). All too often, local revenues capture a declining share of GDP.

Third, there is the effectiveness of revenue collection: that is, to what extent does the local government manage to collect the full potential of that particular revenue. This can be highly problematic to assess in the absence of some basis for calculating the potential of the revenue source. Nevertheless, it is often possible to identify where there is a serious shortfall: large arrears in relation to property tax; property tax rolls that are seriously out of date; the absence of any register of businesses for a business license fee, or the failure to update that register; weaknesses in the revenue administration process, meaning that monies paid do not reach the local government's accounts; the existence of unofficial or illegal levies; and so on. Even the most rudimentary assessment of revenue collection in some of the case studies suggests that their effectiveness is very low.

Fourth, efficiency: that is, the cost of collecting revenues as a proportion of the amounts collected. In principle, revenue collection costs are not difficult to estimate, yet the analysis of efficiency is rarely made. In practice, for our case studies, the reluctance of local governments to divulge information on collection costs made it difficult to make anything other than a crude estimate of efficiency. Nevertheless, it is clear from the cases that collection costs can be very high, in some cases using up most of the revenue collected. This is a very poor use of resources, creating a completely useless burden on taxpayers.[5]

The fifth consideration is equity—how the tax burden is distributed between taxpayers. This is often difficult to determine, especially where taxes and charges on businesses can be passed on to consumers. Nevertheless, it seems clear that levies on small-scale businesses selling mainly to low-income groups are likely to be regressive. Where the problem is non-payment or evasion by larger businesses and higher-income groups—an all too common situation in developing counties—the impact is also highly inequitable and probably regressive. A further problem is that local taxation is often horizontally inequitable, taxing certain groups or sectors that can easily be captured while leaving other groups or sectors untaxed.

Finally, the issue of neutrality. Taxes and other levies on particular sectors and activities influence decisions of consumers and producers. In most cases, such non-neutrality is undesirable, harming economic growth.[6] Much reform of national taxation has been designed to reduce non-neutrality, for example, through the introduction of VAT and the removal of exemptions and other distortionary arrangements. It is inappropriate for local governments to then introduce local taxes and levies that undermine such reforms. Yet in practice, many local taxes do just that, discouraging business enterprise and creating arbitrary, unintended incentives and disincentives for particular activities.

IMPROVING LOCAL REVENUE ADMINISTRATION

Mobilizing local revenues is as much about the administration of those revenues as it is about the design of the tax instruments. This involves a number of elements:

- regular review of tax, charge, and fee rates; adjusting them in line with inflation;
- identifying all those liable to pay, and maintaining up-to-date tax registers;
- correctly assessing the amount of tax liability: this is a particular challenge in relation to local taxes on business, with a sharp trade-off between fairness on the one hand, and the ease of implementation on the other. Only with more sophisticated assessment systems is it possible to make the tax sufficiently graduated to enable a significant amount of revenue to be collected (since flat rates or only moderately graduated tariff structures have to be set at the level which the poorest can afford to pay); yet more sophisticated measurements of the ability to pay are likely to cost more to administer, lead to errors and inequities, and provide opportunities for collusion and fraud;
- collecting the correct amounts in a timely manner, yet without incurring substantial collection costs;
- taking effective enforcement action against non-payers: this can be expensive and time-consuming, especially when court processes are involved;
- accounting for all receipts in a manner that permits cross-checking and reporting; all too often manual systems are wide open to losses and fraud;[7]
- routine and regular cross-checks of assessments against payments, with regular monitoring reports on collection performance, including arrears;
- reviewing systems and processes to ensure that scope for evasion, collusion and fraud are minimized, and that staff resources are being used most cost-effectively;

- taking action to prevent collection of unofficial levies, bribes, and rent-seeking by those, such as the police, who are responsible for managing and regulating economic and other activities.

The case studies revealed severe weaknesses in relation to all of the above issues, but also examples of where reforms had been made.

THE CASE STUDIES AND METHODOLOGY

The study required local researchers to hold the various elements of the study in tension: how revenues can be generated for the local governments from the local economy, much of which is informal. In other words, this was not just a study of local taxation, nor just of the informal sector. Inevitably, some case studies focused more on local revenue generation (e.g., Georgia), while others focused more on the impact on the informal sector (e.g., Indonesia). But between the case studies, some valuable material was gathered about both current practices of local governments (including some interesting innovations), and the possible reforms that could lead to better resource mobilization from the local economy.

The six case studies were (in alphabetical order of country):

- Georgia (Teimuraz Khomeriki): three municipalities including the capital city, Tblisi—to be published at a later date;
- India (Aurobindo Ogra and Debolina Kunda): two municipalities in the state of Uttarakhand plus the city of Bangalore in Karnataka;
- Indonesia (Edi Suharto): street trading in two cities, Jakarta and Bandung;
- Pakistan (Said Paracha and Mosharraf Zaidi): four municipalities in two districts;
- Sierra Leone (Adams Tommy): four cities including the capital, Freetown, one district and one chiefdom;
- Ukraine (Kateryna Pilkevich): three municipalities of differing sizes.

Each case study involved:

- reviewing literature and documentation (studies, reports, legislation, etc.) relevant to the issue in the case country;
- collecting and analyzing national level data (and, where relevant, state/provincial level data) on local government revenues;
- analyzing data on local revenues for the selected municipalities (both budgeted and actual revenues, and including trends over five years);

- making visits to each of the municipalities concerned;
- holding interviews and focus group discussions with officials of central (and state/province) government and the local governments concerned, with local business organizations and associations, and with individual business people and taxpayers;
- identifying examples of good practice and reform initiatives already undertaken.

In many cases, getting access to local government data proved to be a challenge, as did getting local government officials to respond to the issues.

Based on the field research, each researcher developed a number of options for policy reform and developing an advocacy action plan. These are being pursued with the national and local governments concerned.

SOME CONCLUSIONS

The cases studies demonstrated a number of common themes. First, the huge scale of the informal sector, particularly in countries like India, Indonesia, Pakistan, and Sierra Leone, but also in the post-Soviet countries of Georgia and Ukraine. This presents great challenges to the tax authorities at both the national and local levels. Yet it is often the regulatory arrangements adopted by governments, national and local, and the antiquated and inappropriate legal arrangements, that force businesses to operate informally.

Second, the inadequacy of local tax instruments. Apart from property tax, which itself is highly problematic, most case study municipalities have little by way of effective local tax instruments. In Sierra Leone, local governments still rely on a highly inequitable flat-rate poll tax. In Pakistan, provincial governments have arbitrarily withheld local taxing powers from local governments. In Georgia, recent changes have eliminated all but three local taxes, while large-scale exemptions mean that little revenue can be generated from these. In Ukraine, an innovation was the introduction of a simplified system of taxation on small businesses, but that still needs considerable reform to make it effective. In both Ukraine and Georgia, virtually all tax is collected by the national tax administration, even though the revenue may be shared with local governments; thus, local governments have neither the scope nor the incentive to improve local revenue collection.

One consequence of the very limited range of local taxes is the exploitation of nontax instruments, such as business licenses, market charges, building permits, and road tolls (and in Georgia and Ukraine, privatization receipts), to generate revenues. These often have quite negative effects on both equity and incentives (neutrality). Another result is that, even in the capital cities, local governments remain heavily dependant on central transfers, and hence have little incentive to improve their local revenue systems.

Third, the revenue instruments that do exist are often very poorly administered, with much of the revenue potential remaining uncollected. The case studies showed the scale of evasion, collusion, and fraud to be alarmingly high. This also has serious implications for the equity and neutrality of the tax system, particular where larger and more profitable businesses (whether formal or informal) remain untaxed. Moreover, collection costs often absorb a large proportion of the revenue collected (as much as 90 percent in one municipality in Pakistan), creating a huge deadweight for the economy. Nevertheless, the studies found some modest attempts at reform of local tax administration, notably in India and Sierra Leone.

Fourth, and this is perhaps the most significant finding, the local, informal economy is being "taxed," but those taxes are often not generating resources for local governments to improve local service provision. Money that is collected often ends up in the pockets of the revenue collectors, while those with the power to regulate and control economic activities are able to extract "rents" from the informal sector. Not only do such levies create burdens for informal sector businesses, and particularly for the poor, but they also create uncertainty that inhibits the development of such businesses. This was particularly apparent in the cases of Pakistan and Indonesia but applies in other cases as well. Nowhere did there seem to be any serious attempt to curb such unofficial or illegal levies. In Pakistan in particular, there are multiple political interests in maintaining corrupt revenue collection arrangements.

Finally, based on the evidence from interviews and focus group discussions, there is a certain willingness on the part of the business community to pay local taxes in return for services being provided. But at the same time, they want tax liabilities to be clearly defined, small and overlapping levies (particularly unofficial ones) eliminated, and greater assurance that the revenue collected would not be pocketed. This is even more so relevant to informal sector businesses, which claim that they would be more than willing to pay properly defined local taxes in exchange for the right to conduct business without harassment.

These serious problems notwithstanding, there are examples of where modest reforms have been achieved. The most notable example was Bangalore, which has made significant improvements in the collection of property tax using self-assessment, as well as reforming the trade licensing system. Also in India, in the municipalities of Uttarakhand, there have been some innovations in local revenue sources, including an advertising tax and an entry tax on tourists. In Sierra Leone, improvements have been made to the assessment and collection of property tax and business licenses, at least in Freetown and Bo. These reforms have generated significantly increased revenues, albeit from a very low base.

Elsewhere, reform has been more illusive. In Indonesia, local governments have sought to exploit their new levels of autonomy by inventing numerous local revenue instruments that are inequitable, adversely affect businesses, and create rent-seeking opportunities. But the Indonesian case study shows the potential benefits of providing greater security for the informal sector—in other words, greater formalization—and of using associations of street traders as a mechanism for collecting revenues. In Pakistan, the whole reform process is so highly politicized (not least in relation to the future of any form of decentralized government) that it is hard to envisage any serious reform of local revenues taking place in the foreseeable future.

In the cases of Georgia and Ukraine, the centralized nature of tax collection leaves little room for local initiatives at reform. However, both those case studies present proposals for reform of tax instruments that would offer substantial benefits to local government. In the case of Ukraine, the proposals include the introduction of a property tax and reforms to the recently introduced unified small business tax, as well as refining the tax instruments assigned to local government and the reassigning of some centrally collected taxes. In the case of Georgia, the proposals include the introduction of a local sales tax and/or a local income tax, as well as the removal of the many exemptions to property tax. In both cases, the reform would also need to make the municipal level more clearly responsible for the local taxes, even if the actual collection still remains with the national tax administration.

In the end, there is always a balance to be struck between mobilizing financial resources to pay for local services and creating burdens on the local economy, especially for the poor who are involved in the informal sector. But in practice, local revenue potential remains largely untapped, due to lack of suitable revenue instruments, poor administrative systems, and lack of political will. What this study has found is that, all too often, those in the informal sector are often burdened with levies, little of which ever feeds through into the municipal budget to finance improved services. Instead, these resources are being extracted through fraud by tax collectors, illegal levies, bribes, and rent-seeking by officials, leading to both loss of revenue and inequitable tax burdens. Addressing these issues requires confronting vested interests, and so requires a degree of political will that is rarely present.

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NOTES

1 This immediately raises the question about what constitutes local taxation or local revenues, and in particular, whether shared national taxes (a major revenue source in many transition countries) count as local own revenues. For the purposes of this book, local own revenues are those over which the local government has some choice about levying (e.g., setting the tax rate, although that choice may be quite limited), and has responsibility for collecting. Thus, for our purposes, shared national taxes that are centrally levied and collected are not regarded as local own revenues, even though the local government may be free to spend the money as it chooses. However, a problem in most former communist countries is that all (or nearly all) revenue collection is carried out under by the national revenue administration, so that local governments effectively have very little revenue that is really under their direct control.

2 Even here there is great variation, with local governments in the UK financing less than 15 percent of their budgets from local taxation, and around 30 percent from total local own revenues; by contrast, the comparable figures for Germany (state plus local government) are 61 percent and 77 percent, respectively, and for France 45 percent and 72 percent: see Table 1.

3 For example, until recently, there were no central transfers to local governments in Kenya: the consequence of this complete dependence on local own revenues was that most local governments were insolvent and provided few, if any, services.

4 An early conception of the informal sector was that it was outside the tax system. Clearly, this is not necessarily the case, although much tax may be evaded, and greater effort may be required to tap the revenue potential from it.

5 Of course, in some countries and some local governments, the revenue collection "costs" may be regarded as the whole purpose—i.e., creating employment, particularly for political supporters. However, the burden to the economy is wholly negative, not to mention the inequities involved.

6 There are exceptions, where taxation is used to reduce consumption or production of what is regarded as "economic bads," although such an analysis is rarely applied systematically.

7 Computerization does not eliminate errors, collusion, and fraud, but a properly designed computer system makes these much less likely, with in-built cross-checks and a reduced scope for discretion by tax officials.

Local Taxation of Informal Economies

A Case Study of Two Indian States

Aurobindo Ogra and *Debolina Kundu*

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EXECUTIVE SUMMARY

The policy paper on Local Taxation of Informal Economies is an outcome of LGI Policy Fellowship program to support policy research aimed at stimulating innovative and practical policy reform. The research is based on case studies of select municipalities in the states of Karnataka and Uttarakhand[1] in an attempt to identify the local taxation structure of urban local bodies in a country like India where the local economy is largely informal. It analyzes the local tax base of the selected municipalities and identifies the scope for taxing the informal sector based on both secondary and field-based data as well as identifying best practices across the country.

A common feature of urban local bodies (ULBs) is inadequate own sources of revenue, a narrow tax base, and dependence of urban local bodies on state and other fiscal transfers. Own taxes, levies, and user charges of urban local bodies in India are grossly inadequate to meet the expenditure needs of urban local bodies where the economy is largely informal in nature. There are some tax instruments which are unutilized or underutilized where the exclusion from the tax net is a defining characteristic of the informal economy. The analysis of local revenues from small municipality like Mussoorie municipality in Uttarakhand shows that local tax revenue accounts for around 20 percent of the municipality's income, the nontax revenue accounts for around 23 percent, and the other sources like state transfers, etc., account for 57 percent of the total sources of income. The nontax revenues accounts to 54 percent of local own revenues and form a higher share of revenue among the local own revenues. Similarly in case of large municipality like Dehradun Nagar Nigam, the average per capita revenue from nontax sources is observed much higher than the average per capita revenue from tax sources. The street vendors forms the major informal sector and face constraints in investing in and growing their businesses in the absence of formal licensing and fees from the municipality. There is more scope for revenue mobilization by the way of policy interventions like revised user fees, licensing fees, rentals, etc., as compared to the nominal values at present.

Similar to the national level, in Karnataka too, property taxes are relatively more important for bigger ULBs than smaller ULBs, where grants form a higher share of their revenues. An analysis of per capita revenue by various sources and type of ULBs in Karnataka shows that that city corporations generate more per capita revenue than the other classes of ULBs. They generate three times more per capita revenue than the town *panchayats* and double that of city municipal councils. Cesses, fees, and fines were the other major sources of revenue followed by the surcharge on stamp duty. In the case of medium-size ULBs like Nagar Palika Parishads and Nagar Panchayats, nontax revenues forms the largest component of local own sources of revenues comprising of license fees, rents, stamp duties, entry taxes, etc. Street vendors form an important part of local economy and varies according to the size of the cities. The innovative measures adopted by Bangalore Municipal Corporation has resulted in mainstreaming the street vendors as part of the local economy and generating income from local own sources. Until recently, municipalities have paid little attention to mobilizing resources from their own local resources. A majority of the municipalities often does not exercise their potential ability to realize revenues from potential sources in their local economies. There are various classified categories of levies that have not been revised for decades and, at the same time, are not subject to effective taxation. This has largely resulted in evasion of the taxation system, compounded by lacuna in administration, and resulting in the weak financial health of the many municipalities. The evidence from the case studies undertaken show the potential options available for the municipalities to increase their income from own sources.

1. INTRODUCTION

The licensing of businesses by local governments is common in developing economies, including India. It serves two aims: that of regulating business activities and generating revenue for the respective local government.[2] Recent years have seen a sea change in the perception and practice of regulation across the globe. Economies have been "deregulated" in order to stimulate economic growth through the private market.[3] It is argued that the small formal sector typically bears a heavy financial burden and time constraints in complying with tax obligations, which creates a strong disincentive to investment and participation in the formal economy. The more the informal sector is incorporated into the tax system, the wider becomes the relationship between state and citizens. The creation of a deeper fiscal social contract is essential, since tax helps construct state-citizen relations and the mutual obligations between the two.[4] For scholars working on tax policy, the issue of taxation of the informal sector has generally not been of much interest and has been considered too difficult, requiring considerable effort and resulting in no great research outcomes. Rather, the focus of tax reforms has been on simplifying tax systems, widening the tax base, and improving tax administration.[5] Similarly, taxation has not been of principal concern to scholars working on the informal sector.[6]

Research shows that tax evasion is not the primary reason for the units keeping their status informal.[7] Avoiding cumbersome regulations have been noted as more powerful motivation.[8] Araujo-Bonjean and Chambas (2003), on the basis of their survey data, argue that non-compliance with the tax system in the informal sector often results from ignorance of the legislation or the complexity of the tax system rather than from deliberate evasion. Research shows that informal sector operators are willing to pay taxes, specifically when these are in exchange for some legitimacy, predictability, and protection from arbitrary harassment from state agents (Baross and van der Linden 1990, Dickovick, forthcoming, Roever 2005).[9]

In India, the terms "organized" and "unorganized" are used as synonyms of the terms "formal" and "informal" that are used internationally. The organized/unorganized sector is thus used interchangeably with the formal/informal sector, the latter having a standard international definition as recommended by the International Labour Organization (ILO). However, the usage of the terms of unorganized sector and unorganized employment in India lacks conceptual clarity and uniformity across the subsectors of the Indian economy. Employment in the unorganized sector has so far been derived as a residual of the total workers with those in the organized sector, as reported by Directorate General of Employment and Training (DGET).[10] As per the estimates of the National Commission for Enterprises in the Unorganised Sector, the unorganized sector accounted for 86.3 percent of employment in the country in 2004–05.[11] The state of Karnataka accounted for 86.6 percent in 2004–05, slightly above the national average, while Uttaranchal accounted for 87.4 percent.

Few studies have been conducted to study the influence of tax regime on informal economy in India.[12] Sharit K. Bhowmik concluded in his study[13] that Asian governments are by and large indifferent to the needs of the informal sector that constitutes a large part of their urban economy. The goods sold by street vendors are sold to the poorer sections of the society, as they are cheap. Moreover, a significant amount of goods produced by small industrial units in the informal sector is marketed through them.

The National Alliance of Street Vendors in India (NASVI) organized a study on hawkers in seven cities, namely, Mumbai, Kolkata, Bangalore, Bhubaneswar, Patna, Ahmedabad, and Imphal in 2000. In 1998, the Brihanmumbai Municipal Corporation (BMC) commissioned the Tata Institute of Social Sciences (TISS) and Youth for Voluntary Action and Unity (YUVA) to conduct a census of hawkers on municipal lands. In 2001, SNDT Women's University, in collaboration with the International Labour Organization conducted a study on street vendors. Interestingly, all studies found common features among street vendors. Their earnings varied between INR 50 and INR 80 per day for men. Women earned between INR 40 and INR 60 per day and were frequently harassed by the municipal authorities and the police. The NASVI study found that around 20 percent of their earnings are taken as rent by the civic authorities.

India, which figures in the middle rung in the hierarchy among low-income countries, is facing a shortage of resources for the provision of basic services for its growing urban population in general, and the poor in particular. This problem is more serious in towns and cities where the economy is largely informal. Many of the newly formed states,[14] too, are facing difficulties in generating adequate revenues for providing a minimum level of amenities. Most municipal governments in India lack the financial and administrative resources to provide basic urban services. As a result, the urban poor in many cities have resorted to informal mechanisms to obtain basic services. However, the availability of services is very low due to their low capacity to pay, uncertainties of service delivery, and very high costs due to the illegal or semi-legal nature of functioning in the informal market (Cheema 1987, Rondinelli and Cheema 1988, Rodwin 1987).[15]

Urban Local Bodies (ULBs) derive their revenue from own sources consisting of: (i) tax sources and (ii) nontax sources. This revenue is then supplemented by: (i) fiscal transfers and (ii) loans. A common feature of urban local finance across all developing countries is inadequate own source revenues. The devolved sources of revenue do not match a wide range of functions that are required to be performed by them. Local finance is characterized by a mismatch between functions devolved to ULBs and the devolution of tax authority. This mismatch is exacerbated by the lack of: (i) buoyancy and elasticity in local fiscal instruments, (ii) a narrow tax base, (iii) the abolition of a buoyant and elastic source of revenue (*octroi*[16]), and (iv) dependence on only one or two taxes that are not easy to implement (Dillinger 1991).

This policy paper attempts to analyze the main local revenues (both tax and nontax) and their administration in the select cities/towns of India and examine how far such local tax instruments (both tax and nontax) in the informal economy are able to generate adequate revenue, are effectively and efficiently collected and are equitable, neutral and transparent. It also tries to suggest proposals for reforms based on the results of the policy research.

2. RESEARCH PROBLEM

The informal sector is large in most developing countries, including India. Governments obtain little tax revenue from this sector. Exclusion from the tax net is a defining characteristic of the informal economy. On the contrary, licensing of businesses by local governments is a common practice in many cities in India. While business licensing has its origins in regulation, it is often seen as a source of revenue earnings for local governments. Studies on local taxation in India have brought out that there is a mismatch between functions and finances of ULBs, which primarily explains the vertical imbalance. Out of 18 functions to be performed by the municipal bodies in India,[17] less than half have a corresponding revenue source. Own taxes and user charges of the ULBs in India are grossly inadequate to meet the expenditure needs of ULBs where the economy is largely informal in nature. This problem is more serious in the newly formed states that lag behind in the rapid socio-economic changes occurring in India at present. Elaborate state government controls on municipal authorities to levy taxes and user charges, to set rates, to grant exemptions, to borrow funds, etc., and on the design, quantum, and timing of intergovernmental transfers constrain the ability of the ULBs in mobilizing resources. There are some tax instruments, which are unutilized or underutilized. Therefore, the backlog of current and projected growth needed to fund infrastructure in cities and towns, far exceed the resources at the disposal of the ULBs.

3. OBJECTIVES OF THE STUDY[18]

The policy paper is an attempt to achieve the following:

a) Analyze the main local revenues (both tax and nontax) and their administration in the select cities/towns.

b) Analyze how far such local tax instruments (both tax and nontax) in the informal economy:

— Generate adequate revenue,

— Are effectively collected,

— Are efficiently collected,

- — Are equitable—especially in relation to informal sector (which bears the burden),
- — Are neutral (do not create undesirable incentives/disincentives), and
- — Transparent and have built-in accountability.

c) Suggest proposals for reform based on the results of the policy research.

4. SCOPE OF THE STUDY

The focus of the macro-level study is on the local taxation structure of the major states of India. The state level study looks at the taxation structure of two states, viz., Karnataka, a developed state, and Uttarakhand, a newly formed and poorly developed state. At the city level, the taxation structure of Bangalore Municipal Corporation (a metropolitan city) was studied in detail to identify the best practices as well as problems in taxing the local economy in a developed state. Likewise, the local taxation structure of two ULBs in Uttarakhand,[19] viz., Mussoorie and Dehradun, were analyzed to bring about the variations in the taxation structure of large and small ULBs. In these towns as well as in Bangalore, both locally collected taxes and charges like market fees, business licenses, etc., have been analyzed with respect to the focused emphasis on the nontax revenues and the informal sector.

5. AN OVERVIEW OF LOCAL FINANCES: MACRO SCENARIO

5.1 Trend of Municipal Finance in India—An Overview

Urban development is a state subject[20] in India. Therefore, the revenue of urban local governments, their tax structure, type of taxes, fees, and fiscal transfers vary from state to state. However, property tax is the mainstay of municipal finance in almost all states in India except a few where *octroi* is levied. In India, the aggregate revenue of all ULBs is very low, at around 0.75 percent of the country's GDP. Primary data obtained from the budgetary documents of 35 major municipal corporations (MCs)[21] for the period 1999–2000 to 2003–04 reveal broad trends about the structure and composition of their revenue and expenditure in a study conducted by the Economic Analysis and Policy Wing of Reserve Bank of India. Tax revenue accounted for 45.2 percent of total own revenue of MCs, followed by 28.7 percent of nontax revenue during 2000–04. An analysis of the revenues and expenditure of these MCs reveals that most MCs have a revenue surplus and their overall resource gaps are not very large, but a consequence is lower levels of spending than are required for providing a minimum level of civic amenities. This apparent contradiction of sound fiscal health and a high level of underspending is due to statutory obligations, whereby ULBs are bound to restrict their expenditure to the resources available. In India, the revenue instruments, assigned to ULBs by the state governments, at present, are grossly inadequate and not commensurate with the functions expected to be performed by them in accordance with the 74th Constitutional Amendment Act.

National Institute of Public Finance and Policy (1995) studied 293 municipalities in India spread over seven states: Andhra Pradesh (54), Assam (21), Gujarat (63), Kerala (57), Maharashtra (33), and West Bengal (32). The study documents the problems of vertical and horizontal imbalances, the inadequate exploitation of existing resources by local authorities, the high cost of administration and for the collection of local taxes, and an arbitrary system of fiscal transfers from state governments to ULBs as the common features of the municipal finance system in the country.

Kundu, Bagchi, and Kundu (1999) find that the levels of inequity in the provision of basic services across the states and size categories of urban centers are extremely high. Given the resource crunch in state governments and urban local bodies, the authors recommend privatization, public-private partnerships, and the promotion of community-based projects as options for undertaking investments to create civic amenities. However, the aspects of equity are required to be addressed through specific measures.

Bagchi and Chattopadhyay (2004) analyzed the impact of decentralization on the mechanism for financing basic urban services in India. The study finds that domestic institutional funds and external assistance flow to developed states and larger cities/towns. It further argues that the emphasis made on a full cost recovery and the imposition of strict financial discipline on state governments by the Reserve Bank of India are likely to result in a further concentration of funds in developed states or regions and lead to intra-regional disparity.

Chattopadhyay (2004) further examined the impact of decentralization—both revenue and expenditure—on the financial health of urban local bodies through an empirical study of the aggregates of three states in the post-74th Constitutional Amendment Act era. The study observes that decentralization improved the revenue structure of the municipal corporations and positively affected their tax and nontax revenue generation. However, it is only the large urban local bodies that have benefited most from the decentralization initiatives, accentuating inter-regional disparity.

5.2 Best Practices in Municipal Resource Mobilization (Selected Case Studies)

The present section attempts to overview a few case studies pertaining to reforms in municipal resource mobilization in the country.

The Mall Road Entry Fee, Mussoorie Municipality

The town of Mussoorie is predominantly a tourist destination, known as the Queen of Hills among the hill destinations of India. Tourists flock there year-round, whether winter or summer. Tourists enjoy taking long walks along its picturesque Mall Road, which stretches for more than 3.5 kilometers in length. However, due to the high tourist inflow in peak seasons, it was becoming difficult for the municipality to maintain as well as provide services, especially solid waste management, street sweeping, street lighting, etc.

The municipality introduced a Mall Road entry fee, where users were provided with entry permits, especially those wanting to allow their vehicles along the road. The special permits were introduced for permanent residents of the town on a monthly basis system, whereas the entry fee for tourists was based on each entry and valid for certain hours.

For local residents, a permit fee of INR 500 was introduced, where as for tourists an entry fee of INR 100 was introduced. Initially, the municipality managed the system through its own resources and arrangement. However, the system is presently managed based on annual auction or contract system, where bids are invited for the collection and management of the entry fees. The highest bidder to the municipality gets the contract for revenue collection and management of the entry of vehicles to Mall Road.

Over the period of years, the revenue from the Mall Road entrance fee has been a significant source of revenue for the municipality. The revenue collected from this source forms around 10 percent of local own source revenues at the municipal level, showing a growth rate of around 35 percent from 2004–2008.

Eco-Tax System, Mussoorie Municipality

Nestled in the foothills of Himalayas, Mussoorie is a transit town towards the Garhwal Hills and other scenic spots and destinations of Uttarakhand. Within 32 kilometers of the city of Dehradun, known as the "Gateway to the Himalayas," it is frequented by many tourists throughout the year. The town of Mussoorie is nestled in environmentally fragile environment, and in order to care for its environment and ecology, due to the increasing inflow of tourist as well as vehicular traffic, the Mussoorie municipality recently introduced an eco-tax system for all the vehicles entering its jurisdiction. The new tax is expected to substantially contribute to the overall revenue base of local own resources of the municipality. Under the new system, the eco-tax is imposed on various categories of traffic, including: INR 100 from heavy vehicles and INR 30 for cars and jeeps, and INR 5 for two-wheelers.

The objective is to collect revenue for preserving the town's environment and its heritage, apart from maintaining its sanitation and cleanliness. The money will be spent on encouraging plantations and educating tourists against using plastic while in Mussoorie.

Advertisement Tax Reforms, Dehradun Municipal Corporation

With a limited tax base and collection system as well as limitations in increasing property taxes, the municipal corporation in Dehradun analyzed its local own resources and brought innovative reforms to revenue mobilization. After the formation of Dehradun as a capital for the newly formed state of Uttarakhand, business, real estate development, and tourism flourished considerably. As the "Gateway to the Himalayas," Dehradun quickly became the focus of many government institutions, the corporate sector, and business entities. The difference could easily be seen by way of the investments and marketing drives in the city. Billboards around the city were mushrooming without any coordinated effort on the management of advertising revenue by the municipal corporation.

The municipal corporation in Dehradun took the initiative of documenting the number of such billboards in the entire city. It then analyzed the potential of maximizing the revenue from its local own resources by regulating the billboards by imposing a tax. A policy was drafted and introduced for allowing advertising spaces to be auctioned against the assured revenue from a private party that would maintain the billboards, advertisement spaces, manage its clients, and ensure a one-time upfront payment to the municipal corporation. The highest bidder was awarded the contract of managing the entire city's advertisements. The advertisement spaces were sold as per location, sizes, and type like reflective, illuminated, etc. Over a period of years, the municipal corporation has been able to generate around six percent of the local own revenues from the advertisement revenue, with a growth rate of around 33 percent from 2003 to 2008.

With a further, revised advertisement policy, the municipal corporation has fixed the advertisement sites on its seven major roads, and banned hoardings at various places to enhance the the roads, streets, and roundabouts. In one year, the municipal corporation would hardly make INR 5.6 million, but now due to strictness of the corporation, they have received INR 7.2 million from advertisements on poles only. Once this policy comes into full operation, the corporation should make INR 30 million every year only from the advertising, as stated by the mayor of Dehradun municipal corporation.

Trade License Reform in Bangalore

The duty to issue trade licenses in Bangalore vests with the Health Department, which issues license to a broad range of professions, trades, and occupations like healthcare institutions and their employees, for example, hospitals, nursing homes, laboratories, and diagnostic centers, as well as people engaging in trades or occupations that affect the public's health and safety, for example, barbers, beauty technicians, launderers, or hotels and restaurants. The process of obtaining trade licenses in the past was cumbersome, leading to complaints about the delays and official harassment. The issue of licenses was simplified with the introduction of "Suvarna Arogya Paravanige" in 2007. Under the new scheme, for a limited period each year, the trade license was to be automatically renewed and issued within 24 hours. For new applicants the trade license will be issued within seven working days. To cut down on paperwork, the number of documents to be filed has been reduced and a simple application form has been devised. To avoid ambiguity, trades have been reclassified as well as the relevant fees. In the past, if one carried on multiple trades, one had to apply separate for licenses for each trade. Now, under the scheme, only one license will do for multiple trades.

Bruhat Bangalore Mahanagara Palika: Property Tax Self-assessment Scheme

The area-based property tax assessment of the city of Patna became the model for all ULBs to implement widespread property tax reforms. Most of the cities introduced the area-based system during 1999 and 2002. However, after this first revision of property tax, none of the ULBs have been successful in revising their property tax assessment processes except Bangalore, for unless there is a mechanism devised to enable periodic revision of the property assessment values, property tax revenue will stagnate and will lose all its buoyancy. Bangalore is an exception as it has shown how the area-based system can be as effective and revenue productive as in a system under capital valuation. The Bangalore property tax collection that stood at INR 4.4 billion during 2007–08 rose to INR 7.8 billion during 2008–09 and is expected to touch INR 10 billion by the end of 2010.[22]

Bangalore introduced its property tax reforms in 2000 when it first brought forward the optional Self-assessment of Property Tax scheme. Under the scheme the location of the property was classified into zones based on the published guidance value set by the Department of Stamps and Registration. For each of the zones the rental rates per square foot were pre-determined, linking each building to its age, location, type, and quality of construction. The zone, here, refers to a land value category rather than to a contiguous area and hence, a street could fall in any zone in the municipal jurisdiction depending on the rental value assigned.[23]

Bangalore did not bring about the reforms through any amendment of the existing provisions of the Property Tax Act, as any amendment would take considerable time for enactment. Instead it made the scheme optional to avoid any legal challenge. Those who opted for the scheme could assess their property in a manner prescribed under the scheme and those who did not opt for the scheme, would be inspected by the Revenue officials and assessed the property to tax in the same manner prescribed under the scheme. The scheme's objectives were to get property owners to voluntarily declare their property tax liability and to make timely payment. The "inducement" was to free property taxpayers from harassment by tax collectors and to lower the compliance costs of tax payments.

The self-assessment and revaluation reform processes were also politically sensitive. A cap on the property tax increase was set at 2.5 times the existing tax liability. This cap on the net increase in the tax payable also contributed to the taxpayers' success in acknowledging tax obligations since there was a certainty that the taxpayer was made aware that irrespective of the net increase by the new valuation method, he or she would not pay beyond two and a half times the tax paid previously. About two-thirds of all taxpayers reached this cap.

The new initiative did work. In its first year Bangalore's property tax collection increased by 33 percent. It is not just the increase in revenue that mattered. The taxpayers finally understood the norms about how property is assessed to property tax and thus heightened their satisfaction with and the acceptance of the new system. Another success of the reform has been a reduction in compliance costs. The taxpayers were relieved from harassment from the officials, who under the cover of the earlier, opaque system of assessment, forced taxpayers into "negotiated" property tax liability. A well-designed education program as part of the marketing plan for this reform was another reason for its success.

6. THE REVENUE BASE OF ULBS IN UTTARAKHAND (MUSSOORIE AND DEHRADUN)

6.1 Municipal Structure—An Overview

The state of Uttarakhand is located in the northern part of India, carved out of the Himalayas and the adjoining district of Uttar Pradesh on November 9, 2000, becoming the twenty-seventh state of the Republic of India. In January 2007, the name of the state was officially changed from Uttaranchal, its interim name, to Uttarakhand. The provisional capital of Uttarakhand is Dehradun, also a railhead and the largest city in the region. There are three categories of urban local bodies (ULBs) in Uttarakhand: Nagar Nigam (NN) or municipal corporation, Nagar Palika Parishad (NPP), and Nagar Panchayat (NP), the latter two constituting medium- and smaller-size municipalities. There are 63 ULBs, which comprise one Nagar Nigam (NN) or municipal corporation at Dehradun, and 31 NPPs and NPs each. The ULBs of Uttarakhand are governed by the municipal legislation of Uttar Pradesh, viz., the U.P. Municipal Corporation Act of 1959, which is applicable to the sole municipal corporation of Uttarakhand, viz., the Dehradun and U.P. Municipalities Act of 1916, which is applicable to NPPs and NPs.

6.2 Resource Base of Municipalities in Uttarakhand

6.2.1 State Level Overview—Municipalities

The financial condition of most of the ULBs (with only a few exceptions) is not very robust. Their main sources of income are the taxes and fees levied by them, grants from the Central Finance Commission, grants from the state government, and devolution recommended by the State Finance Commission. Nagar Palika Parishads (NPPs) and Nagar Panchayats (NPs) do not have any mandatory power to raise revenue unlike a municipal corporation, which has the mandatory power to levy property tax (including general, water, drainage, and conservancy taxes), animal-ownership tax, and vehicle and boat tax. The discretionary powers given to NPPs and NPs include power to levy taxes on properties, trades, professions, theaters, vehicles, dogs, animals, water drainage, salvaging, and conservancy, in addition to licenses and user fees.

A municipal corporation has the discretion to levy taxes like betterment charges,[24] advertising, professions, dog ownership, and theaters (public entertainment/cinemas). The other sources of revenue are transfers from the central and the state governments (through the mechanism of finance commissions as well as other modes). Some of the ULBs earn revenue by exploiting their immovable assets through rental arrangements or sale.

In actual practice, however, the property tax is the single most important tax (in many cases the only tax) being levied by the municipalities and is also their main source of own income. The other important source of income of the municipalities is licensing fees. These are being levied to a varying extent by all municipalities. In general, the larger municipalities and those located on the plains (the districts of Hardwar and Udham Singh Nagar, the Nainital, Pauri and Champawat districts, and in the Doon valley) are able to raise more money from licensing fees as compared to the smaller municipalities, especially those located in the hills. This is to be expected, since the income from licensing fees is dependent on the level of economic and commercial activity in the urban centers.

Table 1.1

Consolidated Municipal Revenues (Tax, Nontax, Other Sources) (INR 100,000)

No.	Details	2000–01	2001–02	2002–03	2003–04	2004–05
1.	Nagar Nigam Dehradun	1,539	1,505	3,915	2,165	1,606
2.	Nagar Palika Parishads	5,640	7,478	9,973	10,555	9,400
3.	Nagar Panchayats	483	762	1,047	1633	1,326
	Total ULBs	7,662	9,745	14,935	14,353	12,332

Source: Compiled from First & Second State Finance Commission Reports.

Table 1.2
Consolidated Municipal Revenues—Local Own Sources (INR 100,000)

No.	Details	2000–01	2001–02	2002–03	2003–04	2004–05
1.	Nagar Nigam Dehradun	355	469	478	451	324
2.	Nagar Palika Parishads	1,631	1,863	2,219	2,214	2,200
3.	Nagar Panchayats	125	256	229	259	294
Total ULBs		2,111	2,588	2,926	2,924	2,818

The average tax revenues account for 9.6 percent of the total revenues of all ULBs, the nontax revenues on average account for 13.8 percent, and other sources, which include grants and other revenues from the state, account for around 76.6 percent of the total revenues of all ULBs. The distribution of revenues gives a clear picture at the state level that revenues from nontax sources are higher than revenues from tax sources. The nontax revenues account for 59— percent of the revenues from own resources, where as tax revenues account for 41 percent of the total own revenues at the state level. Both the tax and nontax revenues have shown an increasing trend from 2002–03 to 2004–05, which shows the ULBs' dependency on grants and transfers from the state has reduced.

Distribution of Revenues by Type of ULBs

The following table provides a comparison of tax, nontax, and other sources of revenues as a percentage of total revenues and own revenues in different types of ULBs in Uttarakhand.

Table 1.3
Distribution of Revenues by Type of ULBs, in Percent

Type of ULBs	Tax Revenue (Percentage of total revenue)	Nontax Revenue (Percentage of total revenue)	Other Sources (Average percentage of total revenue 2000–05)
Nagar Nigam Dehradun (NND)	11.93	7.54	80.64
Nagar Palika Parishads (NPPs)	8.51	15.01	76.47
Nagar Panchayats (NPs)	8.78	13.38	77.85
All ULBs	9.16	13.49	77.35

The nontax sources of revenues is higher than tax revenue sources among Nagar Palika Parishads (NPPs) and Nagar Panchayats (NPs); however, in the case of Nagar Nigam Dehradun, the tax revenue sources contribute more as compared to nontax sources of revenues. The nontax revenue resources forms the major component of revenue sources from local own revenues in case of NPPs with around 63.82 percent of local own revenues, and around 60.38 percent in case of NPs, whereas in the case of Nagar Nigam Dehradun (municipal corporation), the percentage is the reverse, where the tax revenues contribute to around 62 percent of local own revenues.

Per Capita Revenues at Constant Prices (2003–04)

The average per capita revenues as constant prices are observed to be the highest among NPPs with INR 600, followed by NPs, at INR 459, and is lowest for Nagar Nigam Dehradun with INR 406 (all consolidated revenues). An analysis of per capita revenue of different categories of ULBs shows that the growth of per capita revenue in real terms has been the highest for Nagar Palika Parishads, followed by Nagar Panchayats. The per capita revenue has shown a decline from 2002–03 to 2004–05, for both NPPs, and NPs.

The per capita revenue from tax, nontax, and other sources among the type of ULBs shows that per capita revenue is the highest from the other sources of revenues that include revenues from state transfers, etc. The per capita revenues tax sources are higher than per capita revenue from nontax sources. The per capita revenue among the NPPs is higher than among NNDs and NPs in the case of tax and nontax revenues (Table 1.4).

Table 1.4

Per Capita Revenue from Tax, Nontax, Other Sources (ULBs)

Per Capita Revenue Distribution at constant prices (INR)	NND	NPP	NP	All ULBs
Tax Revenues	57	150	17	189
Nontax Revenues	13	98	10	104
Other Sources	910	3182	368	3,823
Total	117	428	48	505

Table 1.5

Per Capita Income in 2000–2001 Prices (Tax Revenues)

Per Capita Income at 2000–01 prices	2000–01	2001–02	2002–03	2003–04	2004–05
Municipal Corporation Dehradun	55	50	50	46	42
Nagar Palika Parishads	57	140	140	127	134
Nagar Panchayats	93	75	89	120	84
All ULBs	205	266	279	293	260

The per capita nontax revenue at a constant price shows a gradual decrease in case of Nagar Nigam Dehradun (NND) from 2001–02, and a similar declining trend in Nagar Palika Parishads (NPPs) from 2002–03 to 2004–05. In the case of Nagar Panchayats (NPs), the trend shows a gradual increase in per capita nontax revenue from 2002–03 to 2004–05 (Table 1.6).

Table 1.6
Per Capita Income in 2000–2001 Prices (Nontax Revenues)

Consolidated Revenues at 2000–01 prices	2000–01	2001–02	2002–03	2003–04	2004–05
Nagar Nigam Dehradun	108	211	195	165	58
Nagar Palika Parishads	946	1,119	1,356	1,314	1,168
Nagar Panchayats	84	167	119	122	148
All ULBs	1,138	1,497	1,670	1,601	1,374

Table 1.7
Per Capita Revenues at Constant Prices by Type of ULBs

Type of ULBs	2000–01	2001–02	2002–03	2003–04	2004–05	Average
Nagar Nigam Dehradun	344	307	740	379	261	406
Nagar Palika Parishads	469	569	703	690	570	600
Nagar Panchayats	254	368	471	684	517	459
All ULBs	416	484	688	614	489	538

Source: Based on the Second State Finance Commission Report of Uttarakhand.

6.3 Case Study 1—Mussoorie Municipality

6.3.1 Background

Mussoorie (Hindi: Masūrī) is a city and has a municipal board, and it is about 34 kilometers from the state capital of Dehradun in the Dehradun district of the Indian state of Uttarakhand. This hill station, situated in the foothills of the Himalayas, is also known as the "Queen of the Hills." The municipality of Mussoorie was constituted by the British in 1850 and has been run successfully to the present day, with a total staff of 351. In the census of 2001, Mussoorie had a population of 26,069, and the municipality is authorized to execute some public services like birth and death registration, street light maintenance, sanitation and drainage, bus stand and shopping complex maintenance, public grievances, property tax and assessment, traffic and tourist control, ropeway, parking, health and construction department, etc.

6.3.2 Functions of the Municipality

The functions of the Nagar Palika Parishads and Nagar Panchayats are defined in Section 7 and 8 of the UP Municipalities Act as obligatory functions (Annex 12.1) and discretionary functions, respectively. There are 36 functions in the obligatory list and 25 in the discretionary list. The functions broadly include public health, street lighting, sanitation, roads, water supply, urban planning, conservancy, drainage, regulation of offensive and dangerous trades, construction and maintenance of parking lots, public conveniences, etc.

6.3.3 Analysis of Local Revenues

The revenue receipts of Mussoorie municipality shows that local tax revenue accounts for around 20 percent of the municipality's income, the nontax revenue accounts for around 23 percent, and the other sources like state transfers, etc., account for 57 percent of the total sources of income. In terms of revenue from own sources, the local tax revenue accounts for 46 percent, whereas the nontax revenues account for 54 percent of local own revenues. Among the local own revenues, the property tax forms the major source of the total revenue, and accounts for around 13 percent of the total sources, followed by the salvage tax at 3.54 percent. Among the nontax revenues, the rentals from parking, shops, gardens, ropeways, etc., form the highest revenue share of around 10 percent, followed by seven percent from the Mall Road entry fees (a road toll). Among the other state transfers, the share from State Finance Commission accounts for around 44 percent of the total revenue sources.

The local own tax revenues in real terms is showing annual growth on average of 15.7 percent, whereas inflation averages around 4.9 percent, so in real terms (constant 2004 prices), local own revenues are growing at 10.4 percent per year. Although, inflation is below the average growth per year, the local own revenues are not keeping pace with the revenues in real terms. In case of nontax revenues, in real terms the average annual growth amounts to 11.9 percent. The nontax revenues are more than keeping pace with the inflation averaging at 6.5 percent. Adjusting for the annual population growth of 1.73 percent, we find that local own tax revenues per capita are increasing from INR 362 to INR 371 (8.5 percent per year), as are total revenues per capita (27.9 percent) in real terms. However, the municipality has become increasingly dependent on central transfers, with the share of local revenues in total revenues down from 60 to 30 percent.

The highest average growth rate among the components of the local own tax revenues has been observed in the horse and/or pony tax (65 percent), which can be attributed to tourism. Similarly, the highest average growth rate among the components of the local own nontax revenues has been observed in municipal fines (600 percent), followed by copying fees (313 percent), largely attributed to the strict enforcement of fine collection and building permit at the municipal level, after the Supreme Court directives for building permits in Mussoorie city.

The revenue from the Mall Road entrance fee has been a significant source of revenue for the municipality. The revenue collected from this source forms around 10 percent of the local own source of revenue at the municipal level. The Mall Road entry fee has grown around 35 percent from 2004 to 2008.

Table 1.8
Revenues of Mussoorie Municipality (INR)

Municipal revenues	2003–04	2004–05	2005–06	2006–07	2007–08
Property tax (house/occupation tax)	7,950,263	7,934,003	15,113,915	9,511,758	10,334,025
Cycle rickshaw tax	4,945	1,953	8,858	960	3,419
Horse and pony tax	303	1,182	1,188	4,247	1,092
Salvage tax	1,961,672	2,369,946	4,033,165	2,552,451	2,922,322
Slaughter tax	3,757	3,625	3,614	2,283	3,201
Entertainment tax	1,490	1,000	7,454	800	760
Rentals (land, parking, shops, gardens, waterfalls, telescope viewing, ropeways)	7,026,759	3,842,515	7,478,683	9,336,935	11,105,776
Slaughterhouse fees	22,731	25,565	58,159	40,048	45,360
Copying fees	31,829	121,728	285,033	276,173	430,733
Dog registration	90	10	60	50	90
License fees (contractors, photographers, hotels, catering)	136,886	207,086	171,537	420,596	240,741
Miscellaneous (fines, road cutting, encroachment removal)	255,052	34,025	59,865	254,250	107,017
Revenue from interest	193,010	224,102	136,280	1,449,975	1,740,050
Others (Mall Road entry)	8,590,654	4,561,756	5,306,644	5,645,174	6,179,234
Municipal Act fines	4,035	38,335	60,795	95,774	100,963
Security deposits	41,500	103,400	4,500	54,950	34,000
Total local own revenue	**26,224,976**	**19,470,231**	**32,729,750**	**29,646,424**	**33,248,783**

Municipal revenues	2003–04	2004–05	2005–06	2006–07	2007–08
Grants and other transfers					
State Finance Commission	16,250,400	11,404,000	21,135,300	55,315,000	66,215,000
11th Finance Commission	1,336,801	1,371,078	1,823,300	2,115,728	
Miscellaneous (CM fund)			500,000	3,433,000	3,670,000
MLA fund		151,000	49,000	1,212,000	67,270
MP fund	59,736	19,905			
Stamp duty			2,538,530	1,915,360	
Others (tourism)			1,028,040		
Infrastructure			6,690,000	38,633,000	8,000,000
Loan from government (without interest)		4,606,446	35,685		
Total transfers	17,646,937	17,552,429	33,799,855	102,624,088	77,952,270
Total revenue	**43,871,913**	**37,022,660**	**66,529,605**	**132,270,512**	**111,201,053**
Local own revenues as share of total revenue	59.78%	52.59%	49.20%	22.41%	29.90%
Local tax revenues as share of total revenue	22.62%	27.85%	28.81%	9.13%	11.93%
Local nontax revenues as share of total revenue	37.16%	24.74%	20.38%	13.29%	17.97%
Local tax revenue as share of local own revenue	37.84%	52.96%	58.57%	40.72%	39.90%
Local nontax revenues as share of local own revenue	62.16%	47.04%	41.43%	59.28%	60.10%

The Tax Base

At present, the property taxation is based on the ARV (Annual Rental Value) method. The categories for the assessment under the house tax/property tax include: residential, commercial, and institutional structures. There is a separate method of calculation of tax for each type of categories. In case of simple residential structures, it is arrived at by calculation the 12.5 percent of the total assessment derived from the assessed value of the structure. For commercial, and other categories, the structure is different and is based on the cost of construction, cost of land, and fixed multiplier of five percent to arrive at the assessment value.

The rate of assessment is not uniform among Uttarakhand's urban local bodies. In the case of Mussoorie municipality, 15 percent of the assessed value is taken in the form of property tax, whereas it varies in other local bodies of Uttarakhand from 12.5 percent or less.

The following table describes the details of taxation, fees, and user charges levied by Mussoorie municipality.

Table 1.9

Tax, Licensing, User Charges, and Fees in Mussoorie

No.	Description	Tax/license fee/permit details (Annual)
1.	House tax/Property tax (Residential, Commercial, Residential)* (* a breakdown of the property tax is unavailable)	15 percent of ARV
2.	Cycle rickshaw tax	INR 25
3.	Horse/Pony tax	INR 75
4.	Salvage tax	3.75 percent of ARV (Residential) 4.50 percent of ARV (Commercial)
5.	Slaughter tax	INR 7–12
6.	Show tax	INR 10/show
7.	Rentals	Leased Amount/Auction
8.	Dog registration	INR 10
9.	Slaughter fees	
10.	License fee—contractors	INR 300 (Category A), INR 200 (Category B), INR 150 (Category C)
11.	License fee—hotels (Hotels: 176 numbers)	INR 15 per bed
12.	License fee—photographers	INR 205 per license
13.	License fee—food (800 numbers)	INR 20 per license
14.	Copying fees	INR 10–500/per copy
15.	Miscellaneous	
16.	Entry fees (Mall Road), permits	INR 100 per car/entry INR 500 per year (permit fee)
17.	Mutation fees (fees charged for alteration or substitution of title of a person in municipal property records)	INR 500–1,000 per case (residential) INR 1000–2,000 (commercial)

No.	Description	Tax/license fee/permit details (Annual)
18.	Projection fees (extra construction above windows at lintel level for protection from rain/direct sun)	INR 3 per square foot
19.	Hoarding fees	INR 120 per square meter
20.	Kerosene license	INR 500

Administration

The tax collection is managed by eight full-time revenue staff members who are spread over 11 wards of the city. The total area of the city covers around 64 square kilometers, with around 5,000 households and 167 hotels. The tax assessment is done annually for all the categories of the properties like residential, commercial, or institutional. However, the religious organizations and their assets are exempt from the assessment like temples, mosques, churches, religious societies, etc. The assessment notice is sent by post to the taxpayers and if they pay within the stipulated period they receive a 20-percent discount. Around 80 percent of the tax is realized within this period, and those who fall outside this period are subjected to the levy of additional 10 percent in form of fines. At present, tax collection efficiency is around 85 percent. Fraud and/or collusion on the parts of the collectors come in the form of underassessment of the properties or exemption or revised taxation of the properties after the intervention by the tax assessment committee. At present, elected officials form part of the hearing committee for any exemptions, thus influenced by the political system.

The Scope of Nontax Revenues

Nontax revenues contribute almost equally to the share of local own revenues as local taxes. However, there is a more scope for revenue mobilization by the way of policy interventions like revised user fees, licensing fees, rentals, etc., as compared to the nominal values at present. Furthermore, since all the professions, trades, and other actors in the informal sector are covered by the present taxation system, there is more scope to strengthen the nontax revenue sources as they provided a considerable yield in previous years. The municipality has recently introduced levying additional tax in form of an ecological tax on tourists entering the municipal limits, and is expected to contribute substantially to the overall revenue base of the municipality. This is levied as an entry tax for vehicles: INR 100 for heavy vehicles and INR 30 for cars and jeeps.

The Extent of the Informal Sector

The key categories of the informal sector at Mussoorie mainly include street vendors (involved in the business of selling food items, souvenirs, handmade garments/textiles, etc.), cycle rickshaw pullers, and horses and ponies. However, the municipality regulates some of the businesses by issuing licenses and levying fees. The license categories include: photographers, cycle rickshaw pullers, horses and ponies, hotels and restaurants, and contractors. The major category of the business sector that includes businesses by shopkeepers of various categories, traders, retailers, wholesalers, enterprises, etc., are not covered by such licenses and fees except the property tax. The local sales tax or VAT is directly regulated by state government and is not controlled by urban local bodies.

Table 1.10
Categories of Informal Sector in Mussoorie, in Percent

No.	Categories of informal sector	Percentage
1.	Street vendors (Food, souvenirs, handmade garments/goods, readymade garments, footwear)	65.0
2.	Business shops/retail (souvenirs, readymade garments, etc.)	25.0
3.	Bookshops/stationery	4.0
4.	Hardware	2.5
5.	Entertainment/amusement	3.5

Source: Mussoorie Municipality 2009.

The Extent of the Taxation of the Informal Sector

Based on the primary survey, it was observed that informal operators and their enterprises are not subject to taxation; this is mainly due to the political interference and the low scale of the informal sector. However, the average bribe paid by actors in the informal sector to the local authorities range from INR 20–100, depending on the amount of business being done and the location of the street vendor. Presently, permits and/or licenses are not been provided to the informal sector. Based on the field visit, many of those doing business in public space like street traders and vendors do want to pay for their sites. In the absence of formal licensing and fees from the municipality, the informal sector had to pay bribes to the municipality as well as to the police. Due to this system, the street vendors face a constraint in investing in and growing their businesses. The informal sector with categories like food sellers, souvenirs, handmade garments, goods, entertainment and amusement showed a willingness to pay for tax and/or a licensing fee under the regulated mechanism and range from INR 50–300 depending on the type of business and season of operation.

6.4 Case Study 2—Dehradun Nagar Nigam (Dehradun Municipal Corporation)

6.4.1 Resource Base of Revenues

The Composition of the Total Revenues (Tax, Nontax and Other Sources/Transfers).

The municipality of Dehradun, among the earliest of municipalities formed in the nineteenth century, was dissolved in December 1998 to make way for an upgraded institution, that is, the present Nagar Nigam (municipal corporation). The total population now stands at nearly a half million(from the census of 2001), estimated in the absence of the local census data comprising 344,858 people in the old areas of the city, and 102,950 in new areas.

The comprehensive functions of the Nagar Nigam Dehradun are laid down in Sections 114 and 115 of the UP Municipal Corporation Act of 1959, and subsequent amendments; these are classified as obligatory (41 items), and discretionary (43 items), and include public health, street lighting, roads, water supply, urban planning, conservancy, drainage, regulation of offensive and dangerous trades, construction and maintenance of parking lots, public conveniences, etc.

The capacity of the Nagar Nigam Dehradun to fulfill its functions depend upon the resource base that it created from: (i) revenues raised through taxes; (ii) nontax measures and the sale of municipal assets (such as land); (iii) statutory transfers on the basis of the SFC recommendations, (iv) transfers on account of the dispensation of the Tenth, Eleventh and now the Twelfth Finance Commission, (v) state and central government grants on plan or non-plan account, including from the MP and MLA Funds, and (vi) other receipts, including loans from government sources, or financial institutions, if any. Over the period 2003–08, the total revenues of the Nagar Nigam Dehradun went up from just under INR 2 billion in 2003–04 to almost INR 2.7 billion in 2007–08, recording an increase of around 36 percent.

Table 1.11

Sources of Revenue of Nagar Nigam Dehradun (INR hundred thousands)

Sources of Income	2003–04	2004–05	2005–06	2006–07	2007–08
Tax revenues	264.47	256.00	278.20	296.38	354.83
Nontax revenues	231.79	136.92	837.52	1,010.01	176.46
SFC, grants, other income	1,480.55	1,090.74	1,657.28	1,949.69	2,148.57
Total	1,976.81	1,483.66	2773	3,256.08	2,679.86

Source: Nagar Nigam Dehradun.

Among the revenues at Nagar Nigam Dehradun, tax constitutes around 13 percent of the total revenue sources, nontax revenues constitute around 17 percent of the total, whereas the revenues from the state transfers and other sources constitute around 70 percent of the total. Overall, nontax revenues also constitute a major source of income and amount to around 53 percent of the local own revenue, as compared to around 47 percent of the tax revenues. The average nontax revenues have shown a steep growth rate of around 32 percent as compared to six percent from tax revenues from 2003–04 to 2007–08. However, the a much higher average growth rate from tax sources has been observed as compared to nontax revenues from local own sources, and the average growth rate of tax revenues is 36 percent as compared to nine percent from nontax sources, which is mainly attributed to the effective property tax collection and revenue realization of local tax sources It is important to note that the contribution of own revenues to the total resources has declined from 40 percent to 20 percent, from 2005–06 to 2007–08. This reflects the growing dependency on outside sources, mainly the state government, with other sources (including transfers on the SFC account) contributing to more than 70 percent of spending. The Nagar Nigam's performance, measured in terms of own revenue generation per capita stands at INR 120, much lower than that of the Nagar Palika Parishads with an average level of INR 166.

A detailed examination of tax and nontax revenues provides a more complete picture of the potential for raising revenues. As per the trends, tax revenues have shown less buoyancy than nontax revenues.

Receipts from Tax Revenues

Property tax is the major source of tax revenue, and constitutes around 88 percent of the total tax revenues, and around 41 percent of the total revenues from own sources. The per capita property tax has shown a steady increase from 2005–06 to 2007–08, mainly due to the effective property tax revenue realization. Property tax may be levied on all properties within the municipal limits, including state government and central public sector properties, and service charges may be levied on all users of such services. However, as per the Eleventh Finance Commission's examination of the question, central government properties enjoy immunity under Article 285 of the Constitution, on the principle that the sovereign cannot be taxed except with his consent; state government properties and income are exempt from union taxation, with some limitations, under Article 289.

Table 1.12
Tax Revenues from Different Sources of Nagar Nigam, Dehradun (2003–2008)

Heads of Income (INR) Local tax revenues	2003–04	2004–05	2005–06	2006–07	2007–08
Property tax (house/ occupation tax)	24,386,804	23,317,442	23,713,240	25,248,009	29,690,189
Dog/animal tax	1,530	1,380	2,160	1,330	3,500
Advertising tax	1,839,813	2,150,579	3,952,748	4,277,778	5,561,387
Entertainment tax	205,570	131,340	151,995	111,020	228,240
Projection tax (construction)	13,424	78			
Total local tax revenues	26,447,141	25,600,819	27,820,143	29,638,137	35,483,316
Growth		–3.20%	8.67%	6.53%	19.72%
Percentage of total revenues	13.38%	17.25%	10.03%	9.10%	13.24%
Percentage of local own revenues	53.29%	65.15%	24.93%	22.69%	66.79%

(INR in hundred thousands)

Details	2003–04	2004–05	2005–06	2006–07	2007–08
Property tax	243.86	233.17	237.13	252.48	296.90
Percentage change		–4.39%	1.70%	6.47%	17.59%
Property tax as a percentage of tax revenue	92.21%	91.08%	85.24%	85.19%	83.67%
Property tax as a percentage of total revenue from own sources	49.14%	59.34%	21.25%	19.33%	55.88%
Per capita property tax	48	46	47	50	59

Source: Nagar Nigam Dehradun, 2009.

Nontax revenue sources of the Nagar Nigam consist of license fees, *tehbazari* (fees from street vendors), income from rent, fines, and penalties, interest, recoveries against loss of municipal property, and other miscellaneous sources. Among the nontax revenues components, the revenue from stamp fees accounts to the highest component, around 23 percent of local own resources, followed by hotel licenses, parking fees, and rent from land, constituting two percent, two percent, and 1.4 percent, respectively. The nontax revenues constitute around 53 percent of the revenue from own sources and is higher than revenue from tax sources that make up around

47 percent of local own revenues. The average per capita revenues from nontax sources is INR 95, which is much higher than the average per capita revenue from tax sources at INR 50, from 2003–08.

Table 1.13
Receipts from Nontax Revenues in Nagar Nigam Dehradun
(INR in hundred thousands)

Details	2003–04	2004–05	2005–06	2006–07	2007–08
Nontax revenue	231.79	136.92	837.52	1010.01	176.46
Percent change		–40.93%	511.65%	20.60%	82.53%
Nontax revenue as a percent of revenue from own sources	46.71%	34.85%	75.07%	77.31%	33.21%
Nontax revenue as a percent of total revenue receipt	11.73%	9.23%	30.20%	31.02%	6.58%
Per capita nontax revenue	46	27	166	200	35

Source: Nagar Nigam Dehradun.

An advertising tax was introduced by regulating the hoardings and advertising spaces and signage across the city. The advertising/hoarding sites were managed on an annual contract system by auctioning the site spaces on an annual basis to private contractors. A revenue of around 6 percent of the local oven resources was generated from the advertising spaces/hoardings, with a growth rate of around 33 percent from 2003–2008.

7. ANALYSIS OF REVENUE BASE OF ULBS IN KARNATAKA, WITH PECIAL REFERENCE TO INFORMAL SECTOR IN BANGALORE

Recent years have witnessed a shifting of the responsibility for the provision of urban public services to local governments in India.[25] However, corresponding financial resources have often not been devolved to ULBs. ULBs in Karnataka, like other states of India, do not have a large independent tax domain and do not enjoy autonomous revenue sources. Property tax is the mainstay of the ULBs' own financing in the state. The receipts of ULBs may broadly be classified as (a) tax and nontax revenue and (b) grants and loans. It should be noted that while the power to collect certain taxes is vested with the ULBs, powers pertaining to the rates and revision thereof, procedure of collection, method of assessment, exemptions and concessions, etc., are vested with the state government.

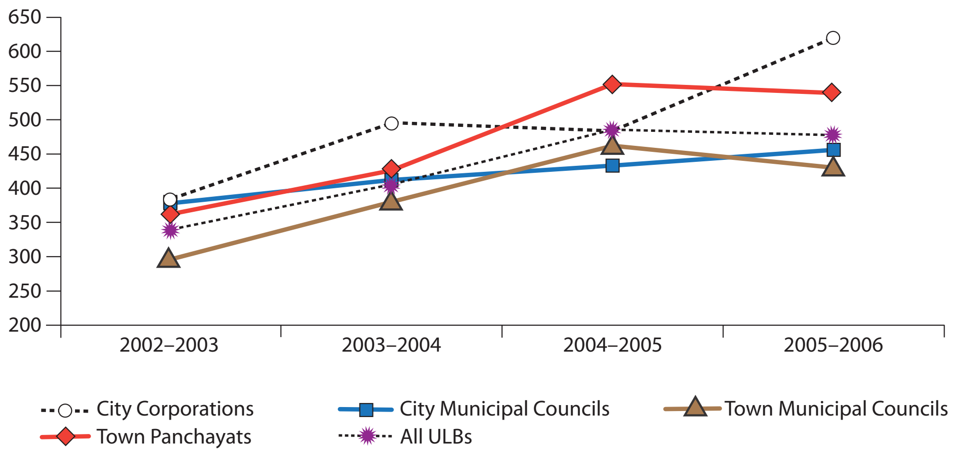
The municipal earnings of ULBs of Karnataka[26] has been analyzed in the present section based on data available in the third State Finance Commission Report of Karnataka. Since local bodies are statutorily not allowed to have deficits in their budgets, their resource gaps (in terms of the resources they really need) cannot be assessed from the budget documents. Hence, the ULB budgets can only indicate the trends in revenue and expenditure and their composition.

An analysis of the per capita revenue of different categories of ULBs is presented here for the period of 2002–03 to 2005–06 (Figure 1.1). The analysis indicates that the growth of per capita revenue in real terms has been highest for the city corporations. A steady growth is perceptible over the years for all classes of ULBs, except city corporations where the per capita revenue registered a slight decline in 2004–05 but picked up in the following year.

7.1 Revenue Base of ULBs in Karnataka[27]

Figure 1.1

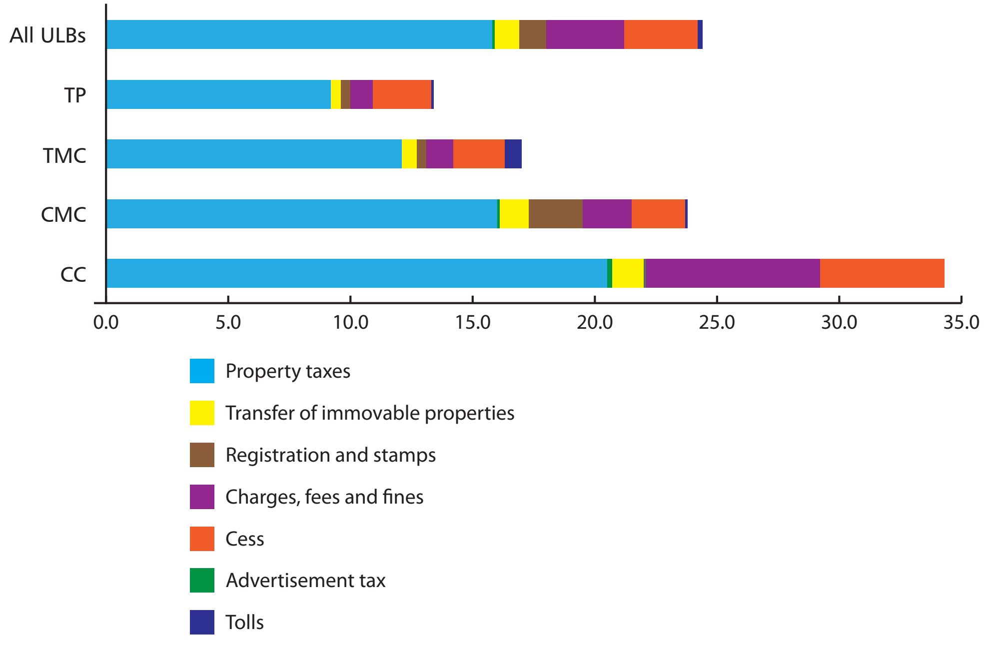
Per Capita Revenue of ULBs of Karnataka by Type of ULBs at Constant Prices in INR



Source: Based on the third State Finance Commission Report of Karnataka.

The percentage distribution of average revenue for the period 2002–07 by various sources and type of ULBs are shown in (Figure 1.2).[28] Property taxes form the major source of revenue for all types of ULBs. The share of property tax decreases from larger to smaller ULBs. Property taxes are relatively more important for larger ULBs than the smaller ULBs where grants form a higher share of revenue. City corporations generate 20 percent of their total revenue from property taxes, compared to 9.23 percent in town *panchayats*. The corporations generate a modest share of their revenue from charges, fees, and fines and cesses, which is not the case for the other classes of ULBs. Here, the share of all types of local own revenue is very small, which is compensated by a higher share of grants and transfers, the percentage of grants being the highest for the smaller ULBs.[29]

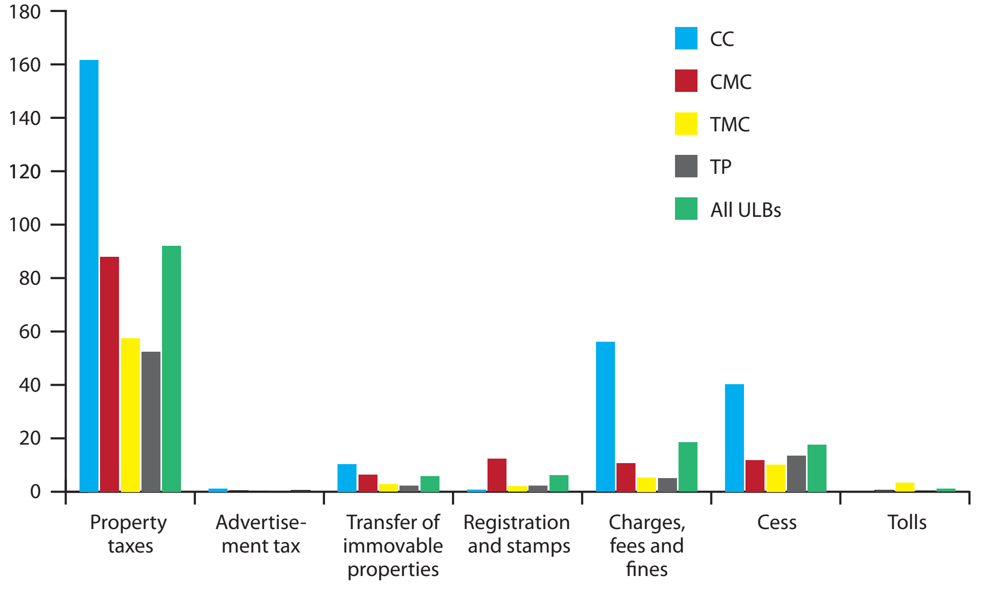
Figure 1.2
Percentage Distribution of Revenues of ULBs in Karnataka by Type of ULBs (2002–2007)



Source: Based on the third State Finance Commission Report of Karnataka.

An analysis of per capita revenue by various sources and type of ULBs for the average of the period 2002–07 has been attempted in (Figure 1.3). The analysis shows that that city corporations generate more per capita revenue than the other classes of ULBs. They generate three times per capita revenue than the town *panchayats* and double that of city municipal councils. Property tax forms the most important source of revenue generation for all classes of ULBs. Furthermore, city corporations are able to generate higher revenue from property taxes as well as from fees/fines and cesses.

Figure 1.3
Average Per Capita Revenue of All ULBs in Karnataka by Type of Revenue at Constant Prices for 2002–2007



Source: Based on the third State Finance Commission Report of Karnataka.

7.2 Revenue Base of Bangalore Municipal Corporation

In 2008–09, with the adoption of the Unit Area Method, property tax collection has increased from INR 3,800 million to INR 7,800 million (see the case study in Section 2.2). This has happened because, for the first time, Geographical Information System (GIS) have mapped the entire city. This has helped in identifying and bringing the properties within the city into the tax net. Over 150,000 unauthorized properties have filed their returns during the 2008–09 tax year.

Table 1.14

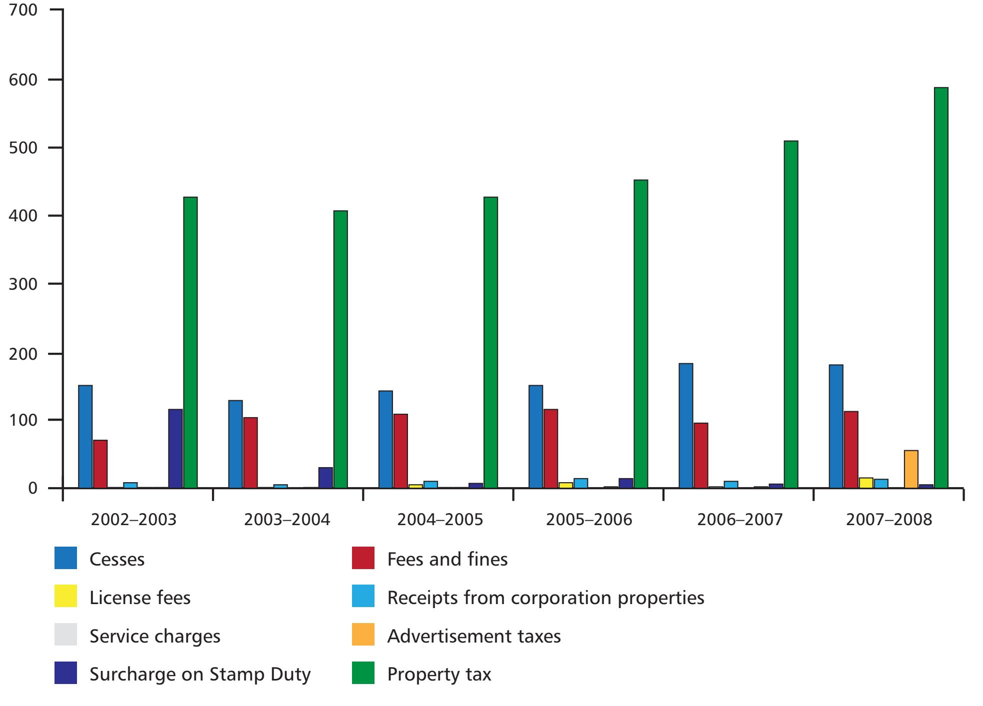
Bangalore: Per Capita Total License Fees and Its Components at Constant Prices

	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08
Hotel and restaurant fees	3.04	3.73	4.22	3.23	3.07	9.42
License fees—us shelters	0.07	0.33	0.54	1.72	0.52	7.96
Power license fees	1.62	1.59	1.86	1.27	0.85	4.97
Others	0.62	0.37	0.63	0.71	0.38	5.20
Total license fees	5.35	6.02	7.26	6.92	4.82	27.55

Source: Calculated from budget documents of the Bangalore Municipal Corporation.

Figure 1.4

Per Capita Total Receipts of Bangalore Municipal Corportation and Its Components at Constant Prices in INR



Source: Calculated from budget documents of the Bangalore Municipal Corporation.

Per capita total receipts at constant prices[30] registered an increase from INR 1,622 to INR 2,633 during 2002–03 to 2007–08. Property tax accounted for the high share of per capita receipts, which increased from INR 425 to INR 574 during 2002–03 to 2007–08 (Figure 1.4). All components of the per capita receipts registered an increase other than surcharge on stamp duty, which registered a steady decline from INR 111 to INR 9 during the same period. Per capita licence fees, which fluctuated between INR 5 and INR 7 during 2002–03 to 2006–07, registered a steep increase to INR 28 in 2007–08. This may be attributed to the increase in trade license fees as well as inclusion of more business in the licensing net with the adoption of the new policy of trade license reform during 2007–08 (as described in Section 2.2).

Incentives and Disincentives

The new property tax collection system created incentives for prompt tax payment by allowing citizens to enjoy a five-percent tax rebate on timely payment of taxes. Those who paid before March 31, 2009 enjoyed a five-percent rebate and they were allowed to file returns without being penalized till April 30, 2009. Furthermore, a disincentive for late payment was built into the system as well. Those citizens paying taxes after the due date had to pay two percent of the property tax as penalty. Also, those who have filed wrongful information would end up paying double the taxable amount evaded, besides two-percent interest per month. If a property owner has paid INR 2,000 less than what he should have paid the penalty would be INR 4,000 plus two-percent interest.

Political Acceptability and Equity in the Unit Area Value System

The involvement of fellow citizens in campaigning for this reform explained in Section 2.2 helped to bring about political acceptability of the tax system. Further, the ruling government supported this move. The steep jump in the voluntary payment of taxes in the first half of this year corroborates the above argument. Equity has been built in the new system as the entire city has been divided into six zones. The tax rates are highest in zone A that has high land and property values and decline systematically with zones B–F representing lower land values. Furthermore, urban slums are fully exempted from the payment of property tax to ensure concerns about equity.[31]

7.3 A Study of Informal Sector in Bangalore

Urban vending is not only a source of employment but provides “affordable” services to the majority of the urban population. The National Policy for Urban Street Vendors (2004) noted the role played by the hawkers in the economy and also in the wider society needs to be given due credit, but hawkers are considered unlawful entities and are subjected to continuous harassment by the police and civic authorities. This is reported to be continuing even after the ruling of the Supreme Court that:

> if properly regulated according to the exigency of the circumstances, the small traders on the side walks can considerably add to the comfort and convenience of the general public, by making available ordinary articles of everyday use for a comparatively lesser price. The policy further mentions that an ordinary person, not very affluent, while hurrying towards his home after a day's work can pick up these articles without going out of his way to find a regular market. The right to carry on trade or business mentioned in Article 19(1)g of the Constitution, on street pavements, if properly regulated cannot be denied on the ground that the streets are meant exclusively for passing or re-passing and no other use.

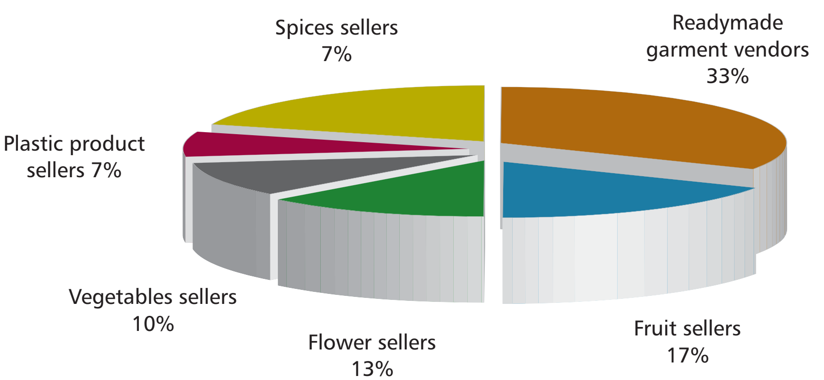
The municipal and police laws of various cities vary with regard to the legal status of the hawkers. Even in other cities, the legal provisions are far from the ones that would encourage or ease the problem of street vendors. Furthermore, in each city, there is a cap on the number of licenses that can be issued in a particular year. In Patna, elaborate details pertaining to the articles sold, place, time of sale and also the stall/booth details from which they will be sold, must be specified to obtain a license. Provision of these details is a hurdle for most hawkers who are generally illiterate. In most cities, the street vendors face heavy fines and harsh punishment if found without a license or working against the regulations. Importantly, the street vendors pay bribes to the local police and municipal officers even if they are paying the license fees to the municipal authorities. This is also true for street vendors, who have a license to run their trade but are not licensed traders. They need to bribe the local police and municipal officers since they feel insecure even if they are paying license fees.

Although street vendors have a significant role in the daily lives of all individuals in the urban areas, they are considered a hindrance in the urban space by government officials as well as the urban vehicle owners, who believe that they occupy what little urban space remains in a rapidly growing country like India and prevent the smooth flow of traffic. The essence of the problem lies with the legal system of the cities, which fails to provide any space to street vending as an activity and recognize its significance in retail trading.

The informal economy makes up a whopping 86.6 percent of the total economy of the state of Karnataka, slightly above the national average.[32] One would also expect the share of informal sector to be even higher in Bangalore, although this data is unavailable at the city level from any government agency. A primary study of the street vendors was carried out in the city of Bangalore to assess the costs incurred in doing business as well as in understanding the their problems in running their business. Three hundred vendors were surveyed at random along the Avenue Road at the city market, which is one of the busiest locations in the city. Interviews were conducted with its informal traders: readymade garment vendors, fruit sellers, flower and vegetable sellers, plastic product and spice sellers, in addition to various street vendors' associations and market and traders' associations to assess the impact of the reforms.

The interview with street vendors brought interesting results across the market. On average, each hawker had to pay bribes of INR 60 on a daily basis to the police (who deal with the flow and regulation of traffic and safety of the citizens using the road) and INR 20 to the municipal corporation officials (who regulate the use of pavements and trade). Compared to the formal payments made by the licensed traders, the informal payments work out to be much higher. The street vendors were not the regular license holders; however, they were keen to apply for vending license. Unfortunately, no designated hawking zones have been planned for Bangalore.

Figure 1.5
Types of Vendors Interviewed



The municipal authority did not really try to bring these street traders under the purview of legislation. It cited the lack of commercial space to accommodate the huge chunk of the informal sector. Moreover, municipal officials were of the view that various other potential sources of revenue like the property tax, could be tapped in order to increase municipal revenue. About 50 street vendors were interviewed from a sample of 300,[33] representing a diversity of trades. More interviews with various traders' associations was also held in the city. But the traders' association expressed their pleasure at the adoption of the reform. According to them, the reform had reduced the time taken to obtain trade licenses from a year to only one week. The Chemical

Association was of the view that the renewal of a trade license could be tied with the annual property tax payment. A few traders' association argued that the traders were already paying sales tax and profession tax to the state government and payment of trade licenses was an additional burden. However, almost all associations unanimously acknowledged the fact that the payment of trade licenses brought legitimacy to the survival of the traders. Further, the recent reforms in the issuance of trade licenses within a period of one week and requiring a minimum of paperwork[34] were cited as a laudable achievement of the local body.

8. CONCLUSIONS AND POLICY RECOMMENDATIONS

Property taxes are relatively more important for bigger ULBs than smaller ULBs where grants form a higher share of their revenues. An analysis of per capita revenue by various sources and type of ULBs shows that that city corporations generate more per capita revenue than the other classes of ULBs. They generate three times more per capita revenue than the town panchayats and double that of city municipal councils. Cesses, fees, and fines were the other major sources of revenue followed by the surcharge on stamp duty. In the case of medium-size ULBs like Nagar Palika Parishads and Nagar Panchayats, nontax revenues forms the largest component of local own sources of revenues comprising of license fees, rents, stamp duties, entry taxes, etc. Street vendors form an important part of local economy and varies according to the size of the cities. The innovative measures adopted by Bangalore Municipal Corporation has resulted in mainstreaming the street vendors as part of the local economy and generating income from local own sources.

So far, municipalities have paid little attention to mobilizing resources from their own local resources, especially those which are not the major components of the revenue sources at present. A majority of the municipalities often does not exercise their potential ability to realize revenues from potential sources in their local economies. There are various classified categories of levies that have not been revised for decades and, at the same time, are not subject to effective taxation. This has largely resulted in evasion of the taxation system, compounded by lacuna in administration, and resulting in the weak financial health of the many municipalities. The evidence from the case studies undertaken show the potential options available for the municipalities. However, the reforms vary in nature and scope and are subject to the political and administrative willingness to bring them about. All these gaps have resulted in revenue leakages, giving rise to an informal system of functioning at various levels. Some of the key recommendations for ULBs to be adopted include:

- The ULBs should adopt a uniform taxation system for various professions, salaried persons, and should switch to the Unit Area Method (UAM) for tax collection.
- There are various professions and trades that have the potential to bring substantial business and financial resources to the municipalities. Under the old valuation system, levies have not produced much revenue, either by failing to bring some professions into the tax net or undervaluation of such trades and professions for defining undervalued levies and taxes.
- Although it is evident that the property tax is the major source of revenue from local own sources, the ULBs can adopt innovative approaches for resource mobilization through local tax administration, as observed from the case studies from two states.
- The mobilization of resources by regulatory and tax administration reforms, for example, an advertising tax, an entry tax or fee at tourist destinations, or the privatization of parking places, thereby generating revenues from informal sector by bringing its actors into the overall tax net.
- The ULBs may introduce and implement new tax revenue for sources like the profession tax and business and trade licenses for various forms of business and professional entities within municipal limits.
- At present, selected professions are subject to effective taxation and levies in the form of licenses/fees as compared to other less popular professions and trades in the excuse of low generating sources. The ULBs should exercise the full implementation of taxation applicable to all professions as per their bylaws and acts.
- The effective regulation and recognition of the informal sector would control revenue leakages and corruption, and bring economic opportunities to the local level.
- The ULBs should take steps to give vendors proper legal status by amending, enacting, repealing, and implementing appropriate laws and providing legitimate hawking zones in urban and economic planning and bring them under the municipal tax net.

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ANNEX 1

1.1 Database

The study is based on secondary as well as primary data. The macro-level analysis has been draw on data from various secondary sources like the Eleventh and Twelfth Finance Commission Reports, various volumes of Economic Survey, the Bulletin of the Reserve Bank of India, etc. Also, reports of various committees and working groups set up from time to time by the government of India and state governments on the subject have been utilized. For the city and town level analysis, primary information (five years, actual) was gathered from the select cities from the respective municipal budgets and through discussions with the concerned officials. Interviews and focus group discussions (FGDs) were also conducted with taxpayers and informal traders, etc.

1.2 Methodology

The study has been conducted at two levels, namely, at the state level taking the size of towns as the units of analysis and town level, taking towns as the level of analysis. Indicators had been constructed to analyze the main local taxes and their administration in the select states and cities/towns. Per capita revenue figures at constant prices had been calculated by deflating the current revenue figures by respective price index. The general consumer price index for non-manual workers has been used for the purpose. For calculating the per capita revenues, projection of population figures of ULBs have been carried out for the specific years of 2003–04, 2004–05, 2005–06, 2006–07, and 2007–08, based on the growth pattern of the previous decade (1991–2001) using exponential growth rates. Interviews and focus group discussions with key officials (state and local levels), taxpayers and informal traders (associations of street vendors, trade associations, business associations, etc.) have been conducted.

ANNEX 2

2.1 Second Phase of Reform

In 2002, the Karnataka Municipal Corporations Act pertaining to the method for the proper assessment of property was amended to bring in a Capital Value System or CVS. While the amended property tax assessment by the capital value method law was introduced in all the urban local bodies, the taxpayers of Bangalore protested against its implementation as they feared that valuation by market value would abnormally inflate the property tax and several resident welfare associations and trade bodies called on the government to amend the law to bring in an area-based system of property tax for Bangalore, similar to the optional scheme introduced in 2000.

In January 2007, seven city municipal councils (CMCs), one town municipal council (TMC), and 110 villages merged with Bangalore Mahanagara Palike (BMP) to form the new Bruhat Bangalore Mahanagara Palike (BBMP). While the erstwhile CMC and TMC were collecting property tax under the CVS scheme, the ARV system was being followed in the erstwhile area under BMP. With the merger of the erstwhile CMCs and TMCs with BMP, there arose the problem of two simultaneous methods of property tax administration: CVS for the newly added zones and SAS for the old BMP area. Hence, there was an urgent need to bring in uniformity in tax administration. Since there was resistance from the taxpayers towards following CVS, the government was forced to concede to the people's request and amended the law to bring in an area-based system of property tax assessment for the whole of BBMP's jurisdiction.

Rational for Adopting the Area-Based System

The property tax is normally based either on the capital value of land and/or building or the rental value it could hypothetically fetch. Alternatively, the property tax base could be derived extracting the essence of both CVS and ARV to arrive at a fair valuation basis. The principle adopted for valuation is:

a) predetermined value per square foot of built up area depending on the location of the property;

b) cost of construction of building depending on roof type or its usage.

This method was defined as "Unit Area Value" (UAV) as the unit of valuation is based on a square foot, depending on the location. The act allows the commissioner to fix the average market rate for different areas or streets and for different classes of building as well as vacant land by a mass appraisal method (gathered through real estate market information or any other reliable source) that he or she considers as reasonable and sufficient. Taxpayers accepted the new tax policy that was legislated as they found that the new system was not in essence different from the old SAS of 2000.

Valuation Process

The fair valuation for each area has to be determined in an objective manner. One of the accepted norms of valuation is to fix value bands based on the published guidance value (GV) of the Department of Stamps and Registration. Each value band then becomes a Value Zone (VZ). On this basis, six value zones within the BBMP jurisdiction were finally notified after seeking public objection, if any, to the classification of zones.

The average expected returns (lease/mortgage/rental/rates) were fixed based on the roof type or usage. Similarly, all commercial and non-residential properties were categorized based on VZ. However, 11 categories of non-residential buildings fall outside the VZ, which will have unit rates based on their kinds of usage.[35]

While fixing a base rate for the year 2008–09, a conscious decision was taken not to increase the rental rates for any of the categories fixed during 2000. This was done to make the new policy acceptable to taxpayers. However, new categories were carved out depending on the usage and type of construction.[36] A rebate of five percent was provided in the act for early payment and a penalty interest rate of two percent per month for those who were tardy with their payments. Owner-occupied properties are to get 50 percent rebate. This rebate is not available for non-residential properties occupied by owners. Also, depreciation was provided for the age of the building.

Under the Act it was mandatory for all property owners to file returns in the prescribed form every year and declare whether they have made any further improvements in the building or changed it usage. If there was no change in the extent of the built up area or its usage a simple return was prescribed. In an event there were changes a separate return form has to be filled up and submitted. All returns filed would be automatically accepted. However, there would be random check of 15 percent of the returns filed.

The Act has made it mandatory for the Commissioner to revise valuation of all properties once in three years by 15 percent. The Council could however revise up to 30 percent for any class of property. The revision will be on the base year 2008–09. The mandatory revision for the block period will thus ensure buoyancy and secondly taxpayers will receive automatic bill informing them of the enhancement. Although there was no increase in the rental rates fixed during 2000, BBMP was able to increase its property tax collection as several properties shifted from a lower zone to a higher zone.[37] This zone classification was made as scientific as possible and every street in the jurisdiction was physically tracked and the zonal location was fixed. After completing this elaborate exercise the zone classification was banded into six value zones and then notified calling for objections and suggestion. After this opportunity the final zone classification was published.

Reasons for Increased Revenue

Though the property tax rental rates were not increased but retained at the same level as during 2000, the property tax collection registered an all time record of over 100 percent increase over the previous year. There are many reasons for this increase. The primary reason is the shift from lower zone to the higher zone. Therefore, despite nearly 30 percent of the property owners in the erstwhile BMP area are yet to file their returns, there is an increase in the tax collection. While the rental rates remained same for all categories listed in 2000, the rental rates for the added categories were consciously made higher since those buildings have the potential for higher rent. Another area that the new law brought to tax net are exempted properties. The new law prescribed that all these properties exempted from property tax under the Act were obliged to pay service charges at 25 percent of the rates fixed for such properties. Another factor that added for increase in revenue emerged from the provision that made it mandatory for all unauthorized properties to file their returns and pay property tax without prejudice for any action that may be taken against such buildings. Over 1,500,000 unauthorized properties have filed their return during the 2008–09. There may be another 2,000,000 more such properties that is still to come under the tax net.

BBMP undertook a simple GIS mapping of all the properties within its 800 square kilometer. All properties were clearly identified and they were given GIS numbers. The GIS map has identified 17 *lakh* properties. However, nearly three *lakhs* properties are identified either as slums and government buildings. BBMP has used the GIS map to place all the returns particulars in the geo-reference in the base map. Hence for those properties that remained blank in the GIS map, automatic notices can be generated. The combination of the shift to one zone higher, service charges for exempted properties, mandatory filing of returns by all property owners and the aid of GIS mapping have contributed for the increase in property tax revenue.[38]

NOTES

[1] In official parlance, Uttarakhand is also known as Uttaranchal.

[2] Devas and Kelly.

[3] Gausch and Hahn 1997.

[4] Moore 2004.

[5] Bird 1992, Goode 1993, Taliercio 2003, Tanzi and Zee 2001.

[6] The focus of attention has largely been on understanding the longevity of the sector, its contribution to the economy and its connections with the formal sector (Gerxhani 2004, Peattie 1987, Fortes and Sassen-Koob 1987). Until recently, the idea of taxing the informal sector might have been considered an oxymoron as one of the key features of informal activities is the ability to avoid taxes. Research suggests that losses from not taxing the informal sector could amount to 35–55 percent of total tax revenues in some countries (Aim and Martinez-Vasquez 2003, Terkper 2003).

[7] Friedman *et al*. 2000.

[8] Ngoi 1997, De Soto 1990.

[9] Negotiating Formality: Informal Sector, Market, and State in Peru. Available online: http://www.wiego.org/occupational.../Roever.

[10] In India, the informal sector is generally used synonymously as the unorganized sector, i.e., those enterprises whose activities or collection of data is not regulated under any legal provision and/or those, which do not maintain any regular accounts. Units not registered under the Factories Act of 1948 constitute unorganized component of manufacturing on account of activity not regulated under any Act. In case of the sectors like trade, transport, hotels and restaurants, storage and warehousing, and services, all non-public sector units constitute the unorganized sector.

[11] In 2005, the total employment (principal plus subsidiary) in the Indian economy was 458 million, of which the unorganized sector accounted for 395 million.

[12] Suresh N. Shende (2002) "Informal Economy. The Special Tax Regime for Small and Micro Business: Design and Implementation."

[13] Sharit K. Bhowmik (2005) "Street Vendors in Asia: A Review." *Economic and Political Weekly,* May 28–June 4, 2005.

14 Three states were split to form three new states during the past few years due to regional demand for autonomy. Thus, Uttarakhand was formed by the Constitutional Amendment Act 2000 by dividing the state of Uttar Pradesh on November 9, 2000. Chhattisgarh was formed by the Constitutional Amendment Act, 2000 by dividing the state of Madhya Pradesh on November 1, 2000. Jharkhand was formed by the Constitutional Amendment Act, 2000 by dividing the state of Bihar on November 15, 2000.

[15] It has been estimated that 30 to 50 percent of the residents of most large Asian cities live in such settlements (Cheema 1988).

[16] *Octroi* is a local tax collected on various articles brought into a town for consumption.

[17] This is part of the decentralization efforts brought about by the 74th Constitutional Amendment Act, 1992.

[18] The methodology and database of the study have been detailed out in Annex 1.

[19] *Uttarakhand* became India's 27th state on November 9, 2000 (formerly known as Uttaranchal).

[20] In India, the power of the states and the Centre are defined by the constitution and the legislative powers are divided into three lists. The state list consists of 66 items and individual states have exclusive authority to legislate on items included in this list. Urban development is such a subject in the state list.

[21] In India, urban local bodies are defined as per their population size. Municipal Corporations are cities with population above 0.3 million.

[22] BBMP, Bangalore, 2009.

[23] A handbook was published to define the zoning of the city for the purpose of the assessment to tax. The division of the city into zones was, in effect, the first level of reform to revalue properties on an annual rental base, but used an approach that features an assessment under a capital value system.

[24] "Betterment charge" means the charge declared to be payable in respect of an increase in the value of land resulting from the execution of a housing or improvement scheme in an urban area.

[25] The 74th Constitutional Amendment (1992) envisaged the creation of local self-governments for the urban population wherein the municipalities were provided with constitutional status for governance. The 74th Constitutional Amendment mandated that a State Finance Commission should be constituted at the expiration of every fifth year for reviewing the financial position of municipalities. The spirit of the 74th Constitutional Amendment was to empower ULBs to function efficiently and effectively as autonomous entities for delivery of capital goods and services.

[26] 160 ULBs.

[27] The urban population of Karnataka was 17.62 million as of the 2001 census and ranked fourth among the highly urbanized states in India. The increase in urban population since 1901 in Karnataka was elevenfold as compared to the rural population, which was threefold. Karnataka has the following five categories of urban local bodies (ULB): eight city corporations (CC), 44 city municipal councils (CMC), 94 town municipal councils (TMC), 68 town panchayats (TP), and 4 notified area committees (NAC).

[28] Here, total transfers and grants includes general grants, specific grants, head of transfer and scheme while others include theater tax, entertainment tax, professional tax, construction or building tax, consumption tax, and duties.

[29] At times, ULBs also levy some other taxes and cesses as a percentage of property tax. These additional levies may be for municipal services or they may be collected on behalf of the state government. In Bangalore, the BBMP levies a certain percentage cess on property tax and collects it on behalf of the government. Thetoll tax is a user fee charged by the ULBs

to cover the construction cost of roads. When property is registered, the ULBs charge a surcharge on the stamp duty.

30 2002–03 prices.

31 Details of the second phase of reforms is given in Annex 2.

32 National Commission for Enterprises in the Unorganised Sector, Government of India, 2007.

33 The remaining 250 hawkers were from the same market and a discussion with the president of the Trader's Union revealed that the system of informal payments was universal throughout the market.

34 Prior to the reforms, various documents were required to apply for a trade license. With the reforms, only proof of ownership and no objection letter from the immediate neighbor is required.

35 The tax rate was not altered from the previous rates and was maintained at 20 percent for residential and 25 percent for non-residential. The 2.5 times cap that existed in the earlier SAS 2000 scheme was removed and all property owners had to pay as per the rates fixed.

36 Average expected market rate per square foot/square meter per month Zonal RateABCDE FResidential5.004.003.603.202.402.00Owner2.502.001.801.601.201.00 Non Residential20.0014.0010.008.006.003.00Owner10.007.005.004.003.001.50The rental rates fixed in the year 2000 for both residential and Non-residential remained same. If an area/street as per present (2008) classification has moved to more than one higher zone then such change in zones shall be restricted to the value (rate) of the immediate next higher zone.

37 The minimum increase in such shift from a lower zone to one zone higher would increase property tax by 15−20 percent. Over 10,000 streets moved from a lower zone to one zone higher in both residential and non-residential property.

38 A comparison of the coverage and the revenue potential shows that while the new applicants have increased by 1,500,000. About 2,000,000 property owners are yet to file their returns. Therefore considering that nearly 0.4 million property owners are yet to file their returns it can be estimated that the property tax revenue could reach about INR 1,000 to 1,200 Crs.

Opportunities and Challenges of Taxing the Urban Informal Economy in Indonesia

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EXECUTIVE SUMMARY

Indonesia has the largest informal economy in the world and the majority of its labor force works in the informal sector. One crucial issue is the opportunities and challenges for taxing the informal economy within the jurisdiction of Indonesian local governments. Focusing on street enterprises in urban areas of Jakarta and Bandung, this study provides a portrait of the informal economy in local economic development and explores how it might be taxed in future.

This study aims to identify the significance of local tax derived from street enterprises in Jakarta and Bandung, and compares the proportion of local government budgets raised by each of these local taxes. In this regard, macro or national level data was generated on local government revenue sources disaggregated by type and tax/revenue instruments. It also provided a window to explore the characteristics of street enterprises in Jakarta and Bandung, including enterprise structures and the economic and demographic characteristics of the operators in order to understand the capacity and willingness of the informal economy to pay tax. Third, it evaluates the perceptions of street enterprise operators towards the practice of tax/user charges collections so as to identify tax compliance and the impact of local taxation and equity effects on the informal economy, particularly on low-income groups, as well as economic distortions caused through undesirable incentives or disincentives. Fourth, it examines the practical difficulties and the scope of abuse in administering the tax collection, including the likely extent of tax evasion, collusion between payers and officials, and fraud by tax collectors.

This research-for-policy project employed the triangulation method. This mixed-research approach refers to a combination of strategies to study the same phenomenon employing quantitative and qualitative techniques of data collection, such as a comprehensive desk review, fieldwork, seminars and focus group discussions, and workshops. The study shows that the informal economy is multifaceted, and hence most studies dealing with it remain vague. Some research papers simply give a list of characteristics of the informal economy by referring to activities which are per se illegal, fail to appear in statistical reporting mechanism, avoid regulatory requirements, or evade taxes, either as part of general fiscal collections or as specific service charges (Shende 2008: 1). This puts the informal economy as merely "petty traders" that powerfully hinder a country's growth rate, locking it into a condition of "emerging but never quite making it," and condemning those living from their unregistered businesses to a lifetime of insecurity and poor living standards (Farrel 2006).

This view, however, is not supported by the evidence. While around the globe the informal economy contains a huge range of businesses (Farrel 2006), this research shows that street enterprises in Jakarta and Bandung could make potential contributions to the local revenues of the cities, albeit not the same, and that they have capacity and willingness to pay tax and user charges to authorities. The potential contributions of street traders to local revenues in Bandung are relatively higher than in Jakarta. This is partly determined by the capacity of local governments in gaining revenues from their own sources. The local revenues in Jakarta are notably higher than that of Bandung. The main source of revenue in Jakarta is also mainly derived from its own source revenues. The local revenues of Bandung are mainly derived from transfers from central government.

It is not true that the informal economy and tax evasion is identical. This study supports the research findings of Joshi and Ayee (2008) that tax evasion is not the primary reason for continuing in the informal domain. While their level of income shows their potential capacity to pay tax and user charges, their willingness to pay fees is high and in the majority. However, noting that their incomes vary, and for many of them it is quite low, and involving daily and cash transactions, the informal sector's activities are most likely to be regulated under user charges rather than tax. According to the law, district and municipality governments are allowed to collect user charges from street vending. In Bandung and Jakarta, collection of fees from street traders is possible since it is explicitly stated in Perda K3 (Kebersihan, Ketertiban, Keindahan) or the Local Regulation on Cleanliness, Orderliness, and Attractiveness of the Cities.

This research-for-policy project has outlined evidence-based research on opportunities and challenges faced by local urban governments of Jakarta and Bandung in collecting revenues (taxes, fees) on predominantly informal economies. Except for the potential contributions of street trading to local revenues, in general, the trajectory of findings in two cities under study shows similar trends. These findings form lessons and recommendations for effective taxing of informal economic activities that can be applied in other local governments in Indonesia and elsewhere.

The question is what strategies can be formulated to deal with such opportunities and challenges? In terms of increasing local taxation from street enterprises, the issue of regulation and formalization is central here to be addressed. Here, the extent to which formalization or regulation depends on the nature and characteristics of the informal economy in each particular region. It is clear that informal enterprises, even large ones, choose to stay that way if there is no change in the factors that generally drive them into informality, that are, high corporate taxes and the bureaucratic burden of operating formally.

Therefore, the strategies that can be developed should take into account such a question as why do those involved in street trading remain informal? First, if the factor is related to profit margins in the informal sector, which tend to be quite small, that regulation means the destruction of the activity itself. In this case, regulation in the way that it applies to formal establishments may not be suitable for those in the informal businesses. Regulation and tax will lead to economic distortions caused through undesirable disincentives. Second, if the factor has something to do with procedures and practices of the formalization of trading that are often overly difficult, then formalization can be selected as a strategy to deal with the informal economy.

In the case of street traders in Jakarta and Bandung, the second scenario is closer to the findings. The capacity and willingness of street traders in Jakarta and Bandung are relatively high and viable for local taxation. The formalization of street traders can be applied through a review of regulatory processes. It is argued that once the regulations and procedures are relaxed and improved, street traders will almost automatically follow the formalization of their business activities, including formal taxation. Discussions with resource persons and participants of seminar as well as interviews with government officials in Jakarta and Bandung lead to a number of initial policy recommendations. In order to effectively and efficiently apply local taxation into the street trading, four options merit attention:

1. Taxation of the informal economy is possible and viable in terms of economic and legal concerns, especially for those traders operating their business in fixed and appointed locations. Such a tax needs to take into account the characteristics, typology, and economic scale of the trading. For example, user charges may be higher to those operating businesses in the attractive locations and obtaining high revenues.
2. Jakarta and Bandung have already Perda (local regulations) related to the collection of user charges. However, the regulation is only a part of the Perda on Cleanliness, Orderliness, and Attractiveness based on an "eradication" paradigm rather than a "regulation" approach. Therefore, regulating local taxation of the street traders needs a specific Perda using new approach under the paradigm of good governance. In terms of user charges, it also needs to be clearly stated that the fees collected will be associated with specific government services.
3. It is clearly noted that the capacity and legitimacy of local governments in managing the tax are low. The improvement of good governance, including the enhancement of government official commitment and administrative capacity, are highly demanded.
4. Collection of tax or user charges needs to involve street traders' associations, especially in collecting fees on a daily basis. The capacity building of such associations is required to improve their skills and commitments in doing such tasks.

1. INTRODUCTION

1.1 Background

As in many other developing countries, the informal economy in Indonesia still accounts for much of the total employment in the country. It has created a more equitable distribution of incomes in rural and urban development, but also poses a great source of potential revenues for local governments.

During the 1980s and 1990s, the number of those who constitute the working-age population and who depend on the informal economy as their main source of employment and income has been consistently more than sixty percent of the total labor force (see: Sethuraman 1985, Evers and Mehmet 1994, Firdausy 1995, Azis 1997, CBS 2001, Suharto 2002). In 2007, it consisted of 43 million in rural areas and 14 million in urban areas or about 65 percent of the total working-age population (CBS 2008). This clearly shows that Indonesia has one of the largest informal economies in the world.

Since businesses within the informal economy are not officially registered and consequently lack the required licenses or permits to operate, their contribution to the payment of taxes has not been explored and encouraged. For local governments, whose own source revenues in Indonesia are quantitatively and relatively low in local budgets, even a minimal amount of tax revenue from the informal economy would be a huge step toward greater financial autonomy. In 2003, for example, own source taxes and charges made up less than eight percent of total local revenues; as such, the interest in expanding the local tax base is quite important for Indonesia (Lewis 2006: 214).

In line with changes in control over local sources of revenue, the importance of local taxation in Indonesia is influenced by at least four issues (Lewis 2006: 214–215). First, it is well known that local governments were given the authority to create their own taxes and charges under the government's decentralization program, the implementation of which began in 2001. Second, local governments seem to have created many of their official new revenue instruments in an extralegal manner. Third, the conventional wisdom in Indonesia is that many of the newly established local revenue instruments were found to be economically harmful. Fourth, corruption linked to local taxation has become more than a "public secret" under decentralization.

1.2 Research Questions and Objectives

The interest in examining opportunities and challenges of taxing the informal economy within the jurisdiction of local governments in Indonesia is one of the crucial issues. These pose a number of questions about local taxation of the informal economy by local government. Is it possible for local governments to expand their revenues from the informal economy? Does the informal economy make significant contributions to local taxes? What are the impacts of local taxes and levies on the informal economy? What are the issues of tax abuse relating to unofficial levies, and the losses to local government through collusion, fraud by tax collectors, and rent-seeking by enforcement staff? How should the management of taxing the informal economy be administered? In order to respond to such research questions, the objectives of this study are to:

1. Identify the significance of local tax derived from street enterprises in Jakarta and Bandung, and compare the proportion of local government budgets raised by each of these local taxes. In this regard, macro/national level data on local government revenue sources disaggregated by type and tax/revenue instruments were also analyzed.
2. Explore the characteristics of street enterprises in Jakarta and Bandung, including the enterprise structures, and the economic and demographic characteristics of the operators in order to understand the capacity and willingness of the informal economy to pay tax.
3. Evaluate the perceptions of street enterprise operators towards the practice of tax/user charge collections so as to identify tax compliance and the impacts of local taxation and equity effects on the informal economy, particularly on low-income groups, as well as economic distortions caused through undesirable incentives or disincentives.
4. Examine practical difficulties and the scope of abuse in administering the tax collection (i.e., identification, assessment, collection, and recording), including the likely extent of evasion, collusion between taxpayers and officials, and fraud by tax collectors.

2. THE URBAN INFORMAL ECONOMY AND LOCAL GOVERNMENT REVENUES

2.1 Definition of Informal Economy

The informal economy is known by many different names according to different contexts and points of view (Suharto 2002 and 2008). Variously referred to as the informal sector, the unregulated economy, the unorganized sector, or unobserved employment to cite but a few of its titles, this economy typically refers to both economic units and workers involved in a variety of commercial activities and occupations that operate beyond the realm of formal employment. These economic activities involve simple organizational, technological, and production structures. They also rely heavily on family labor and a few hired workers who have low levels of economic and human capital and work on the basis of unstandardized employment laws.

The informal economy is multifaceted, and hence most studies dealing with it remain vague. Some research papers simply give a list of characteristics of the informal economy by referring to activities which are per se illegal, fail to appear in statistical reporting mechanism, avoid regulatory requirements, and evade taxes, either as part of general fiscal collections or as specific service charges (Shende 2008: 1). This labels the informal economy as the domain of mere "petty traders" that puts a powerful brake on a country's growth rate, locking them into a condition of "emerging but never quite making it," and condemning those working in unregistered businesses to a lifetime of insecurity and poor living standards (Farrel 2006).

Historically, activities in the informal economy were not included in national employment statistics. In an attempt to bring this sector to national attention as well as to reduce the concern over high unemployment, the inclusion of the sector in national figures has now become a common feature in many developing and developed nations alike (see Portes, Castells, and Benton 1989; Thomas 1992; Williams and Windebank 1998). However, the activities of the informal sector, which are mostly unregistered and unrecorded in national income accounts, are still the main determinant in referring to the sector as informal. The main reason is that the activities are almost always outside the scope of state regulation and protection. Even if their activities are registered, the informal sector does not follow any labor protection, job security, and other protective measures of the workplace (Williams and Windebank 1998).

In the urban context, the informal economy often consists of small enterprise operators selling food and goods or offering services, and thereby involving the cash economy and market transactions. This urban informal economy is more diverse than in rural areas and includes a vast and heterogeneous variety of economic activities through which most urban families earn their livelihoods. The main forms are retail trade, small-scale manufacturing, construction, transportation, services, and domestic work operating either as home or public activities. Activities of the urban informal economy in the public arena of cities are particularly apparent in street-based trading. The people engaged in street enterprises are termed as street traders or in what Indonesians commonly call *pedagang kakilima* (PKL). Though these street enterprises are mostly hidden from the state for tax reasons, they involve very visible structures, and are often subject to certain limited administrative processes, such as simple registrations or daily fee collection (Suharto 2005).

This characteristic raises challenging issues and demands an evidence-based study to analyze the experience of selected local urban governments in Indonesia (i.e., Jakarta and Bandung) in collecting local government revenues (taxes and fees) on predominantly informal economies, and to draw lessons and recommendations for the effective taxation of informal economic activities that can be applied to other local governments in Indonesia and elsewhere.

2.2 The Issue of Legality

One of the most hotly debates regarding the informal economy is related to the legal aspect of the sector. This involves four dimensions (Mead and Morrisson 1996, Suharto 2002).

1. Registration. The informal economy is regarded as an enterprise that is not officially registered or does not have a required license or permit to operate.
2. Payment of taxes. The informal economy does not pay taxes or operation-related costs.
3. Regulations of working conditions of the labor force. The informal economy does not make payments for social insurance or payments for minimum wages and paid holidays.
4. Other institutional regulations and requirements that are legally binding on producers and traders are often absent in the informal economy, such as those designed to protect consumers, control the quality of the product, or restrict the location in which the enterprise is permitted to operate or sell (Suharto 2002).

The issue on the legality of the informal economy still provokes a lively debate. From the beginning, the definition of informal economy in both developed and developing countries is always connected to the concept of legal and illegal activities (e.g., Hart 1973, de Soto 1989, Rakowski 1994, Mead 1994, Thomas 1995). Thomas (1992 and 1995), for instance, distinguishes between legal and criminal activities, according to the nature of the outputs and the production and distribution of the outputs sold with reference to the impact of the policy implications: governments may seek to encourage legal informal activities, but would discourage those that are criminal.

Based on this view, Thomas (1995:13–14) argues that the goods and services of the informal sector are regarded as legal, but that the production and/or distribution is "quasi-legal." Although the informal sector may not follow the law, either in the production (e.g., not comply with the industrial safety or minimum wages or social security) or in the distribution of the product (e.g., through tax evasion), what it produces is not illegal. In contrast, the production and distribution of the criminal sector is entirely illegal, because the sector produces and distributes goods or services that fully break the law. For example, drugs and robbery in many countries, or gambling and prostitution in Indonesia, are considered illegal both in the production and distribution of these outputs.

In the case of street enterprises, this urban informal economy operates their businesses in the areas that can be classified as public spaces, which are not originally intended for trading purposes. therefore, most, if not all, street enterprises operate without licenses. For example, more than 90 percent of the street enterprises in Bandung operate without licenses (Suharto 2002). Some of them, however, have some kind of identification.

The common identification is mainly in the form of a registration card with a photo stating the name of the owner, his or her main type of trading, and specified location (Suharto 2005).

Although the informal sector is located outside the scope of state regulation, including taxes, there are some kinds of "retributions" (user charges) that have to be paid by them. Most street enterprises in Bandung pay registration fees (Suharto 2002). Street vendors near an office building, public park, or market also rent regular stall space or pay a daily fee to set up a table or squat on the path. In 2000, the fees vary according to the value of the stocks and the attraction of the business location, but it generally costs between IDR 300 and IDR 1,000 per day (Suharto 2002). Other expenses, which are under the table and negotiable, include security fees, more often paid to illegal "police" or informal watchmen known as "*jeger*" (derived from Mick Jagger, leader of the Rolling Stones) in the local language (Suharto 2002). As will be discussed in Section Four, this form of multiple levies is observed in all the study areas.

The licenses, rental, and security fees generally make street vendors safe from eviction, although this sort of business authorization is not protected by the law. Conversely, a lack of payment almost certainly leads to a convenient excuse for harassment and eviction. Of course, formally and openly, authorities do not encourage such trading. Yet, in many main and secondary streets, vendor operations are tolerated most of the time. But they may be driven off the street by the police as part of a temporary smartening up of the city environment during national or international celebrations.

In such events, street enterprises, viewed by city authorities as unsophisticated or unsightly, were covered temporarily to prevent important people or potential investors from seeing them and gaining a negative impression of the city. Once the celebrations finished, however, the traders went back to the streets and the city dwellers, including the authorities and the police, began again to purchase fresh fruits, cigarettes, second-hand goods, clothes, and shoes from the street enterprises.

Thus, although it is problematic, the existence of the street enterprise in developing countries often results from the real condition of the country: governments cannot provide enough work opportunities and social security to the unemployed and the poor. One important implication of this condition is that the "guilty feeling" of the government leads to a double standard regarding the informal sector: authorities may be fully aware of the unwanted effects of the street enterprises but may choose not to enforce the rules, either because of lack of staff or resources to do so, or because of concern that this would drive the enterprises out of business, with a consequent loss of employment (Mead and Morrisson 1996: 1,612).

2.3 Local Tax and the Informal Economy

The issue of the taxation of the informal economy has generally not caught the attention of most professional specialists working on tax policy. Similarly, scholars working on the informal sector have no strong concern on taxation of the sector. The focus of many studies on the informal sector has been on its contribution to the economy and employment creation, its connections with the formal sector (backward and forward linkages), and its relationships with the issue of poverty (Joshi and Ayee 2008, Suharto 2002 and 2005).

There is also little literature providing a practical guide on how to widen the tax base to include the informal sector, for taxing the informal economy is complicated in view of its economic, administrative, and political aspects. It is also considered difficult to do and requires a great amount of effort with few returns (Devas 2008, Joshi and Ayee 2008, World Bank and DFID 2008, Shende 2008, Kuehn 2007).

The informal economy is complex and heterogeneous, encompassing large and small enterprises, rural and urban establishments, owners as well as workers, and local activities versus those that cross jurisdictional boundaries.

Most, if not all, informal economic activities are unregistered, with some involving underground, clandestine and illegal activities, and are therefore hardly appear in statistical reporting mechanisms.

- The informal economy is dominated by cash transactions, making data collection and tax registry difficult.
- The difficult of collecting revenue from the informal economy means that the administrative costs of tax collection can be higher than actual tax yields.
- The low profit margins and low productivity of most informal activities means that the tax burden may have a great impact on reducing employment creation in the local economy.
- Politicians tend to see the informal economy as an unpopular policy choice and they often make implicit contracts with those involved in informal activities to allow tax evasion in exchange for political support.
- Collusion between taxpayers and officials increases the likely extent of evasion and fraud by tax collectors.

The fact that the informal economy is very large, encompassing much of the labor force in most developing countries, and that governments obtain little tax revenue from this sector, has dissuaded scholars from focusing their attention on the possibility of taxing the informal economy. But it is argued that extending taxation to the informal economy is not only based on pragmatic arguments, but also on longer-term political perspectives on the taxation relationship, that is, accountability (Joshi and Ayee 2008).

Joshi and Ayee (2008, 184) stated that in so far as economies of developing countries are becoming increasingly informaliszed, policymakers should find ways to tax this sector if the formal sector is not to bear an oppressive tax burden. They also affirmed that taxing the informal sector more effectively will make governments more legitimate, and enhance the positive relationship of taxation and accountability as an indication of robust democracy. Joshi and Ayee (2008: 186–188) furthermore outline six factors important to direct taxation of the informal economy:

1. Growth of the informal sector. Recent calculations from developing nations reveal that the contribution of informal economy to GDP varies from between about 20 percent of GDP in Indonesia to around 67 percent in Bolivia; and that it accounts for over 40 percent of GDP in twenty-four of the fifty-five countries under study.
2. Revenue needs. Research shows that losses from not taxing the informal economy could amount to 35 to 55 percent of total tax revenues in some countries. The clear challenge for governments then is to map this potential and large source of revenue, whilst simultaneously keeping the costs of collection and administration low.
3. Impact on tax compliance in the formal sector. Since the informal economy continues to operate untaxed, the formal sector taxpayers perceive the state as being unfair in pursuing them for taxes. Thus, whilst ignoring taxation of the informal economy decreases morale, it increases the risk of low tax compliance elsewhere.
4. Demands from the informal sector. The informal sector itself does not reject to taxation as one might expect. Some studies suggest that tax evasion is not the primary reason for being informal. It was found that informal sector operators are willing to pay taxes, especially when these are in exchange for some legitimacy, predictability, and protection from arbitrary harassment from state agents. Formal taxes are likely less costly than the bribes extracted by public officials "informally."
5. State legitimacy. In countries where those involved in the informal economy are more than half of the population, state legitimacy is at stake. Expanding the tax base and developing a "culture of compliance" is important not only for increasing revenues, but also for a means of re-engaging citizens with the state.
6. Links between taxation and accountability. It is argued that governments that are dependent on "earned" revenues such as taxes—as opposed to "unearned" revenues such as aid or mineral wealth—tend to be more responsive to their citizens. Equally typical, citizens who pay taxes are more likely to demand responsive governments. Therefore, integrating the informal economy into the tax net can stimulate constructive engagement with the state, particularly in terms of making claims and realizing rights.

2.4 Local Governments and Revenues in Jakarta and Bandung

In order to finance services and activities for which local governments are responsible, they need resources and revenues; and under their control, local governments have the authority to collect local taxes and charges (Devas 2008). Borne by residents of the jurisdiction, these revenues are to fund at least part of the cost of services that benefit those residents (Devas 2008: 23). However, the reality is often far from the expectations. In most countries, local revenues sources meet only part, and even sometimes quite a small part, of local expenditure needs (*Ibid.*).

In Indonesia, as indicated earlier, local governments own source revenue is quantitatively small. As shown in Table 2.1, local government own source revenue by category for 2003 consisted of local taxes, user charges and fees, and various other types of revenue. The table reveals that each of the three main types of local revenue contributes roughly the same amount to total own source revenue.

Table 2.1

Actual Local Government Revenue, Indonesia 2002–2005 (in IDR billion)

Revenue items	2003		2004		2005*	
Local government revenues	111,300		118,594		124,875	
Original revenues	8,603	100.0%	9,464	100.0%	10,023	100.0%
Local taxes	3,128	36.3%	3,727	39.4%	3,908	39.0%
User charges and fees	2,768	32.2%	3,308	34.9%	3,736	37.3%
Other local government own revenues	2,706	31.5%	2,430	25.7%	2,379	23.7%
Transfers	93,755	100.0%	104,581	100.0%	110,525	100.0%
Tax shares	9,927	10.6%	11,333	10.8%	10,061	9.1%
Nontax shares/Natural resources	10,403	11.1%	11,091	10.6%	11,779	10.6%
General allocation funds	70,230	74.9%	73,329	70.1%	78,627	71.2%
Special allocation funds	3,193	3.4%	3,022	2.9%	4,225	3.8%
Tax share from province	0	0.0%	5,806	5.6%	5,832	5.3%
Other Revenues	3,942	100.0%	3,493	100.0%	4,171	100.0%
Local government financing	12,728		12,301		12,475	
Total	124,029		130,894		137,350	

Note: * Based on Anggaran Pembangunan Daerah Bruto (APDB).

Source: CBS (2009).

Table 2.1 shows that whilst local government own revenues from 2003 to 2005 are dominated by local taxes revenues (around 36.3 and 39.4 percent), there is no significant difference in the contribution between user charges and fees, and other local government revenue components. However, the above table illustrates that the contribution of the informal sector is quite small compared to the formal sector. As we know, local taxes are derived from the formal sector, whilst remunerations are received from both the informal and formal sectors. The total contribution of user charges and fees to local revenues increases, ranges from 32.2 to 37.3 percent during 2003 to 2005. During the period, the contribution of user charges and fees increased about 0.8 percent.

In the past decades, local government in Indonesia depended heavily on central government in terms of revenues and financing. Central government provided transfers and subsidies of up to 90 percent to support districts. The decentralization process introduced in 1999 has motivated district and municipal governments to increase their capacity and self-reliance. Local governments now have more opportunities to manage their own resources, making them less reliant on the central government and potentially more efficient.

Since 1999, the implementation of regional autonomy laws—Laws No. 22/1999 and No. 25/1999—has changed the structures of relations between central and local government, particularly in the area of administration and finance. Law No. 34/2000, furthermore, which was launched to regulate the types, tariffs, and administration regulations of local taxes and other local revenues (user charges, local state own revenue, and others), and provides greater possibility for local governments to generate their local revenues.

The Law No. 34/2000 separates local taxes and user charges into two category—the first is taxes and user charges that can be collected by provincial government, whilst the second by cities or municipalities. Four categories of taxes that can be collected by provincial governments are motor vehicle taxes, the transfer of registration fee for motor vehicles, taxes of motor vehicle fuel, and taxes for using ground water. Whilst seven categories of taxes belong to the city or municipality governments, namely, taxes on hotels, restaurants, public entertainments, advertising, street lighting, mineral extraction type C, and parking (Sidik 2002).

Table 2.2 shows local government revenues in Jakarta and Bandung for the period of 2005 to 2007. It was found that the main sources of revenue in Jakarta and Bandung are different. Jakarta, having the status of both a province and a city, has access to a much larger pool of local own revenues, notably on motor vehicles. As a result, own source revenue account for 56.8 percent, 54.5 percent, and 57 percent of the city's budget in 2005, 2006, and 2007 respectively. By contrast, the city of Bandung's budget is dominated by transfers from central government, which account for 84.9 percent and 87.4 percent in 2005 and 2006, respectively.

The table also highlights the relative importance of local taxes in own source revenues in Jakarta as well as in Bandung. Although this data is too aggregated to be useful, it would be fair to say that the contribution of the informal sector is mainly through fees and charges rather than local taxes, since local taxes are mainly paid by the formal sector.

According to Law No. 34/2000 and its supporting regulations, provincial governments are prohibited from collecting other taxes apart from what have been regulated. However, district and municipality governments are allowed to collect other taxes, as long as these do not violate the criteria of tax collection described as follows:

- It is a tax in nature, which is different from user charges;
- The tax object should be residing in the area of the region, with low mobility, and a residential-based population;
- The base and object of the tax should confirm the social justification;
- The local tax object should not overlap with those owned by the central and provincial governments;
- The tax potential should be significant;
- The tax should not distort the economy;
- Equity and the ability to pay tax should be the concern of the tax policy; and
- Environmental considerations should be a priority.

Table 2.2
Local Government Revenue in Jakarta and Bandung, 2005–2007

Source of revenue	2005		2006		2007	
	IDR (billion)	Percent	IDR (billion)	Percent	IDR (billion)	Percent
Jakarta						
Transfers from central government	5,770	43.2	6,520	45.5	7,572	42.9
Own-source revenue of which:	7,599	56.8	7,817	54.5	10,084	57.1
Tax-based	6,514	48.7	6,483	45.2	8,334	47.2
Non tax-based	138	1.0	213	1.5	250	1.4
Others	947	7.1	1,121	7.8	1,500	8.5
Total revenue	13,369	100.0	14,337	100.0	17,656	100.0
Bandung						
Transfers from central government	na	na	1,879	84.9	2,970	87.4
Own-source revenue of which:	na	na	334	15.1	427	12.6
Tax-based	na	na	189	8.5	245	7.2
Non tax-based	na	na	18	0.8	20	0.6
Others	na	na	127	5.7	162	4.8
Total revenue			2,213	100.0	3,397	100.0

Source: Extracted from Provincial Government of Jakarta, Financial Statistics (2005–2007) and the Municipality and District Government of Bandung, Financial Statistics (2005–2007).

2.5 Working Population of the Informal Economy

It is clear that in Indonesia the informal economy is the main source of employment for a large majority of the total working population, and therefore could potentially contribute a large amount to local revenues. According to newspaper reports and discussions with resource persons during seminars and interviews with municipal government officials in Jakarta and Bandung, it is estimated that in the five municipalities of Jakarta the number of street enterprises in 2008 is between 80,000 and 100,000, whilst in the Greater Bandung district and municipality the number is between 30,000 and 50,000 vendors. This estimation is close to other calculations. For example, Jakarkta's Statistics Office reported that in 2006 there were about 13,941 street vendors located in temporary appointed-legal sites and 3,408 establishments located in "*lokasi binaan*" or permanent appointed-legal sites, and about 75,402 street traders operated in unregistered locations (DPRD Jakarta 2007).

As has been indicated earlier and will be explored further in the next sections, although the "special" characteristics of the informal sector locate the sector outside the accountable and transparent coverage of local levies, there are local levies that are collected by the municipal governments, so they are not entirely outside the tax system. Moreover, in addition to local levies, the nature of the informal sector makes them vulnerable to other forms of levy by unofficial collectors and rent-seeking by official collectors.

3. OPPORTUNITIES AND CHALLENGES OF TAXING THE INFORMAL ECONOMY

So far, this project has outlined evidence-based research on opportunities and challenges faced by local urban governments of Jakarta and Bandung in collecting revenues (taxes and fees) in a predominantly informal economy. Except for the potential contributions of street trading to local revenues, in general, the trajectory of findings in two cities under study shows similar trends as well as pointing to possible solutions for effective taxing of informal economic activities that can be applied by other local governments in Indonesia and elsewhere.

As elsewhere, street vendors in Jakarta and Bandung agglomerate around potential business locations. They surround the markets (*pasar*), shopping areas (*pertokoan*), and commercial complexes, trading food, commodities, and services to city dwellers. In addition to these locations, the street traders, mainly food sellers, also converge at the entrances to schools, universities, and hospitals, providing food to students, patients, staff, and visitors. Street enterprises in Jakarta and Bandung are widespread in many different places. Yet their locations always reflect their reliance on economic activities that were either located on, or affected by, the street. Thus, while many street enterprises may clearly be drawn from the main roads or intersections, some of them clogthe sidewalks and pathways, reflecting their physical proximity and access to the streets.

In selling a variety of items and services, the vendors are found in various places and structures. Table 2.3 shows that the majority of vendors use kiosks/stalls for their wares and operate their business during the day and night and in fixed locations. It was found, however, that a few street traders are mobile. They sometimes shift and roll their locations from, for instance, the pavement near a school in the morning to the roadside at the entrance to a square, park, or movie theatre, where crowds congregate at night.

Table 2.3

Profiles of Street Vendors in Jakarta and Bandung

Variables	Jakarta (Percent)	Bandung (Percent)
1. Types of structure		
▪ Mat	4	16
▪ Kiosk/stall	58	31
▪ Pushcart	18	28
▪ Pushcart with tent/cover	20	25
2. Time of operation		
▪ Daily (6 a.m.–6 p.m.)	34	41
▪ Evening (6 p.m.–midnight)	8	24
▪ Day and night	58	35
3. Mobility		
▪ Fixed in one location	92	89
▪ Mobile	8	11
4. Types of trading		
▪ Street food enterprises	39	30
▪ Street goods enterprises	54	58
▪ Street services enterprises	7	12
5. Working capital (value of stock)		
▪ Less than IDR 100,000	15	16
▪ IDR 100,100–IDR 500,000	49	52
▪ IDR 500,100–IDR 1,000,000	32	25
▪ More than IDR 1,000,000	4	7
6. Daily incomes*		
▪ Less than IDR 100,000	33	36
▪ IDR 100,100–IDR 200,000	35	30
▪ IDR 200,100–IDR 300,000	22	26
▪ More than IDR 300,100	10	8
n_1 (Jakarta): 135; n_2 (Bandung): 105		

Note: * The average daily income of street traders in Jakarta is IDR 149,100; in Bandung is IDR 111,289.

Source: Data collection in 2009.

In Jakarta and Bandung, some street enterprises, especially good traders, are quite large operations. As Table 2.4 shows, most street vendors in Jakarta (49 percent) and Bandung (52 percent) have working capital or value of stock between IDR 100,000 (about USD 10) and IDR 500,000 (about USD 50), and even 32 percent and 25 percent of street traders have working capital between IDR 500,000 and IDR 1 million. Although many street traders obtain a daily income of less than IDR 100,000, their daily average net incomes are still relatively high: about IDR 150,000 in Jakarta and IDR 111,000 in Bandung. This makes street traders' monthly "wages" higher than the monthly salary of high-ranking government officials as well as commerical factory workers. It was found that some traders, especially those with a working capital of more than IDR 500,000, are involved in supermarket chains, money exchange, software distribution, auto-part supply, electronic trading, and other manufacturing products.

Table 2.4 indicates that street traders in Jakarta and Bandung are willing to pay taxes, especially user charges, when these are in exchange for some public services, such as public cleaning, electricity and water facilities, security and protection from harassment from state agents and illegal "police" as well as some legitimacy and predictability regarding their business operations. In view of their business operations, which are on a small-scale with daily cash transactions, most street traders prefer to pay user charges on a daily basis.

Table 2.4

Willingness of Street Vendors to Pay Tax in Jakarta and Bandung

Variables	Jakarta (percent)	Bandung (percent)
1. Willingness to pay tax		
▪ Strongly agree	2	7
▪ Agree	18	15
▪ Neutral	45	37
▪ Disagree	28	36
▪ Strongly disagree	7	5
2. Willingness to pay user charges		
▪ Strongly agree	59	49
▪ Agree	16	33
▪ Neutral	14	10
▪ Disagree	8	6
▪ Strongly disagree	3	2
3. Government services demanded as returns for user charges		
▪ Security (especially from illegal "police")	21	21
▪ Cleanliness	20	9
▪ Electricity	10	14
▪ Water	7	9
▪ Protection from eviction	30	31
▪ Legal business location	12	16

Variables	Jakarta (percent)	Bandung (percent)
4. Preference to system of payment		
▪ Daily	79	65
▪ Weekly	11	17
▪ Monthly	4	13
▪ Yearly	6	5
n_1 (Jakarta): 135; n_2 (Bandung): 105		

Source: Data collection in 2009.

Data in Table 2.5 reveal the connection between the informal economy and the reality of informal taxation in Jakarta and Bandung. In both cities, government officials argued that no formal taxes are being taken from street traders. They mentioned, however, that user charges are indeed applied to some street traders in some appointed areas of the cities. Nevertheless, in practice, they are equivalent to taxes, since no services are being provided directly and exclusively to the payers.

Table 2.5

Practice of Tax Payment and Perceptions

Variables	Jakarta (percent)	Bandung (percent)
1. Amount of daily user charges paid*		
▪ Less than IDR 2,500	12	17
▪ IDR 2,600–5,000	15	23
▪ IDR 5,100–IDR 7,500	30	20
▪ IDR 7,600–IDR 10,000	36	32
▪ More than IDR 10,000	7	8
2. Payment collectors		
▪ Government officer	36	48
▪ Illegal "police"	14	10
▪ Do not know	29	20
▪ Others	21	22
3. Time of payment		
▪ Pay earlier	8	6
▪ Pay on time	82	78
▪ Pay later	10	16
4. Perception towards amount of payment		
▪ Higher than my earnings	28	26
▪ Just right	66	69
▪ Lower than my earnings	6	5

Table 2.5 (Continued)

Variables	Jakarta (percent)	Bandung (percent)
5. Perception towards benefit of user charges		
▪ It can promote my business	46	43
▪ It has no benefit for my business	38	40
▪ It can decrease my business	16	17
6. Government services received		
▪ Security (especially from illegal "police")	60	51
▪ Cleanliness	20	38
▪ Electricity	12	7
▪ Water	0	0
▪ Protection from eviction	0	4
▪ Legal business location	8	0
7. Perception towards accountability		
▪ All money goes to local government	12	13
▪ Largest amount of money goes to local government	16	16
▪ Fifty percent of money goes to local government	20	14
▪ Only smallest portion of money goes to local government	22	21
▪ No money goes to local government	30	35
n_1 (Jakarta): 135 n_2 (Bandung): 105		

Note: * Average daily user charge paid in Jakarta is IDR 7,818; in Bandung is IDR 5,244.

Source: Data collection in 2009.

In fact, all street traders in the two cities mentioned that they pay user charges every day. The average daily user charges paid in Jakarta is IDR 7,818; and in Bandung is IDR 5,244. The amount varies according to their business scale and the place they operate. In Jakarta, for example, 12 percent of street traders pay less than IDR 2,500; 81 percent pay between IDR 2,600 and IDR 10,000; and seven percent pay more than IDR 10,000 per day.

It was reported that some street traders in Simpang Market in Bandung that operated at night even pay IDR 17,000 per day. Based on interview with Sugiman—head of neighborhood administration/authority in Simpang—who manages and directs the levies collection in that area, the amount of money is established on the agreement of three parties: the municipal government, the street traders themselves, and the neighorhood administration/authority. Of the total amount of IDR 17,000, IDR 15,300 is paid to neighborhood authority for security, a tent, and a booth (including the assembling), and electricity services, and IDR 1,700 goes to the local government, in which IDR 700 is for public cleaning and IDR 1,000 for market retribution (based on Perda/Local Legislation No. 11/2005).

However, it appears that the total amount of the charge that is paid to local government varies from one place to another. For example, according to Deni Syarif, a tax collector in the Kosambi area of Bandung, every street trader has to pay IDR 3,000 on a daily basis. According to him, IDR 1,000 is the charge that goes to local government, whilst the fee for electricity and cleaning is IDR 1,000 each. He sends the collected money to the local government every week, whilst the public cleaning money is sent directly to the public cleanliness officer every day. Since the electricity comes from the market, Deni pays the money to the market management officer on a daily basis.

Whereas Sugiman pays IDR 700 to local government, Deni claims that he pays IDR 1,000 to the local government. However, he does not provide any ticket—neither to street traders nor to the local government—for every transaction made. Since the Local Planning Board claims that the local government produces tickets for every transaction, it appears that Deni receives the tickets from the local government but he keeps them. He "manages" the ticket in such a way that he determines the amount of money that will be paid to the local government.

In Jakarta, Bang Boim, the tax collector in Pasar Minggu claims that he performs as the "assistant" of the local government in collecting market charges from street traders. He collects IDR 2,000 for the market charges, IDR 2,000 for the cleanliness services, IDR 2.000 for electricity services, and IDR 2.500 for "*jasa preman—japrem*" (security service) which will prevent the street traders from eviction. Paying the money to local government on weekly basis, he never uses the ticket for the charge, meaning that there is no proof that the money paid by street vendors goes directly to local government. This condition is similar to the Kosambi area in Bandung.

This form of multiple levies is evidence in all areas surveyed. In addition to regular charges, street vendors in the Kosambi area in Bandung and the Sunday Market in Jakarta who sell pirate CDs and DVDs are even required to pay "extra" fees to the "public security" officer (*Petugas Tibum*) and police personnel. In return, the authorities provide them with information regarding the eviction schedule. This quasi "protection" makes street traders safe from "cleanliness" operation suddenly done by *Petugas Tibum*.

Levy collectors play an important role in collecting charges from the street enterprises in both Jakarta and Bandung. The procedure of collection process is usually something like this. The charge coupons that originally come from municipal government are then distributed to the subdistrict (*kecamatan*) government. The collectors come to the street enterprises, collect the fees, and give the coupons as the receipt. Once a week, member of municipal government takes the collected money from the collectors. The total money taken is based on the amount of returned coupons.

However, this procedure is not as simple as it seems. In practice, the management control of retribution collection from local governments is very limited. In South Jakarta, for instance, the retribution coupons distributed from the municipal government to the *kecamatan* cannot effectively be collected according to an actual target. The total returned coupons—and therefore the total amount of money received from retributions fee—is always very little compared to the actual number of street enterprises. According to Trityatmo Bowolaksono, a staff member of the Board of City Development Planning, contribution of retribution fees to the local revenues in South Jakarta is only about one to two percent of the potential.

In-depth interviews with street traders indicated that the low contribution of street traders to local revenues is mainly caused by "deals" between taxpayers and tax collectors. In most cases, the official collectors perform as the main actor. They often illicitly take the money from the street enterprises without giving coupons as receipts. Consequently, instead of going to the government, the money goes into their own pockets. In order to hide this wrongdoing, tax collectors collaborate with "unofficial" levy collectors who act on behalf of them in collecting retributions. Most of them are informal watchmen. This practice is done to establish transactions without any receipt as well as to minimize the time in collecting the money.

In Jakarta and Bandung, formal taxes are likely less costly than the bribes extracted by public officials on an "informal" basis. Secondary data supports this fact. For example, in 2005 it was estimated that if 60 percent of the existing street enterprises in Jakarta pay user charges between IDR 3,000 and IDR 10,000 per day, in a year government would receive a total revenue about 30 billion. User charges applied to the street vendors are based on a zoning system in which areas with high traffic mobility and business opportunities are charged the highest tariff of IDR 10,000 per day (*Tempo Magazine* 2005). According to a member of Parliament of Jakarta, H.M. Nakoem, user charges obtained from 92,751 street traders in Jakarta that should come to the financial accounts of the local governments should not be less than IDR 34 billion. But in reality, in 2006 the real amount was reported only IDR 24 billion (DPRD Jakarta 2007). Although it is only a general calculation, this argument indicates that if the taxes are well-managed then the contribution of the informal sector to local government revenues will be significant.

Table 2.4 also provides information about the capacity and legitimacy of local governments in Jakarta and Bandung in collecting user charges. It was found that street traders in Jakarta Bandung perceived that governments can provide certain services (i.e., security and cleanliness) that are in line with their expectations. However, government services in providing water facilities, protection from eviction and legal business operation are lower than expected. The level of state legitimacy is perceived as low in the eyes of street traders. This is partly caused by the fact that the level of services provided by the government is determined by the contribution of user chargers. As mentioned earlier, collusion between taxpayers and officials occurred in many level of retribution collection. As a result, the revenue received from charges is much less than the potential. This condition, therefore, determines the level of services provided by governments.

Most respondents in Jakarta (52 percent) and Bandung (56 percent) believe that only the smallest portion of, and even no money at all, derived from user charges goes to local government. This evidence is similar with the findings based on the interview with tax collectors in Jakarta and Bandung. In addition, interviews with some street traders in Kosambi, for example, revealed that the actual levies they should pay based on the coupon is IDR 700–IDR 3,000. However, Table 2.5 shows that most of street traders pay more than the amount stated in the coupon or ticket. This indicates the low level of accountability of the government since the confidence of the taxpayers that revenues are actually used fairly is low. Most respondents claimed that they pay on time to collectors since most of the transactions are made on a daily basis (see Table 2.4). They also said that the amount of payment is fairly fitting with their earnings. Street traders in Jakarta (38 percent) and Bandung (40 percent) perceived that user charges have no benefit for their business. However, although 16 percent and 17 percent of street traders in Jakarta and Bandung, respectively, said that user charges can negatively effect their businesses, most street traders in both cities, 46 percent and 43 percent, respectively, believe that user charges are important for promoting their ventures. Street traders will do anything to keep their customers. Moving to other places due to eviction is a catastrophe that could ruin their businesses. Since the user charges are able to prevent eviction, most street traders believe that paying their user charges on time means keeping their regular as well as irregular customers.

On the basis of the estimated number of street enterprises in Jakarta (between 80,000 and 100,000 establishments) and in Bandung (between 30.000 and 50.000 vendors), the potential contribution of revenues can be drawn (Table 2.6). For example, if all street traders in Jakarta (100,000 people) and Bandung (50,000 people) pay IDR 7,500 per day, yearly revenues of the Jakarta and Bandung governments from street enterprises would be IDR 270 billion and 135 billion, respectively. In Jakarta, such an amount of money would account for 2.7 percent of its 2007 own source revenue; whilst in Bandung it would account for 31.6 percent of the city's own source revenue.

In comparison with the actual local government revenues in 2003–2005 as mentioned in Table 2.2, the general calculation above indicates that the contribution of user charges and fees from the informal sector would provide a significant payment to the local government revenues. This is particularly the case for Bandung, where the total contribution reaches 31.6 percent from the actual yearly revenue in 2007.

Table 2.6

Scenarios of Revenues from Street Enterprises in Jakarta and Bandung

Local government	User charge IDR/day				
	Scenario 1 IDR 700/day	Scenario 2 IDR 1,000/day	Scenario 3 IDR 2,500/day	Scenario 4 IDR 5,000/day	Scenario 5 IDR 7,500/day
Jakarta					
▪ Yearly revenue (billion)	25.2	36	90	180	270
▪ As percent of 2007 own source revenue (IDR 10,084 billion)	0.25	0.36	0.9	1.8	2.7
Bandung					
▪ Yearly revenue (billion)	12.6	18	45	90	135
▪ As percent of 2007 own source revenue (IDR 427 billion)	2.95	4.21	10.5	21.1	31.6

This table indicates that a certain proportion of street traders contribute at a lower rate of tax, whilst the other segment contributes a much higher tax to the local government revenues. Through this calculation, it can be estimated, based on Table 2.6, that all of the street traders in both Jakarta and Bandung would possibly be able to contribute 26 billion and 18 billion in Jakarta and Bandung, respectively, through a IDR 1,000 user charge per day. The maximum percentage of street traders who would be able to pay user charges as mentioned in scenario 3 is 73 percent in Jakarta and 60 percent for street traders in Bandung, whilst there are only about 36 percent street traders in Jakarta and 32 percent in Bandung who would be able to pay a IDR 7,500 user charges per day as stated by scenario 5. From this calculation, it can be concluded that the possible amount of user charges that can be subjected to every street trader based on their actual user charge amount in Jakarta and Bandung is IDR 1,000.

4. CONCLUSIONS AND INITIAL POLICY RECOMMENDATIONS

Although the informal economy is claimed as multifaceted, and hence most studies dealing with it remain vague, this view is not supported by the evidence collected here. Whilst around the globe the informal economy contains a huge range of businesses (Farrel 2006), this research shows that street enterprises in Jakarta and Bandung have the potential to contribute to local revenues of the cities, albeit not equally, and that they have the capacity and willingness to pay tax and user charges to authorities. The potential contributions of a share of revenues in Bandung are relatively higher than that of Jakarta. This is partly determined by the capacity of local governments in gaining revenues from their source. Local revenues of Jakarta are notably higher than that of Bandung, since Jakarta has two sources of revenues: provincial and municipal revenues. The main source of revenue in Jakarta is also mainly derived from its own source revenue. Local revenues of Bandung are mainly derived from transfers from the central government.

It is not true that the informal economy and tax evasion are identical. This study supports the findings of Joshi and Ayee (2008) that tax evasion is not the primary reason for being informal. Whilst their level of incomes shows their potential capacity to pay tax and user charges, their willingness to pay fees is high. However, noting that their incomes vary, with many of them having very low incomes, and involving daily and cash transactions, the informal sector's activities are most likely to contribute through user charges rather than tax. According to the law, district and municipality governments are allowed to collect user charges from street vending. In Bandung and Jakarta, the collection of fees from street traders is possible since it is explicitly stated in Perda K3 (Kebersihan, Ketertiban, Keindahan) or the Local Regulation on Cleanliness, Orderliness, and Attractiveness of the Cities.

This study has also explored how street traders as charge payers evaluate local governments in Jakarta and Bandung in providing public goods that benefit them; and in reflecting the legitimacy and capacity to make all taxpayers shoulder their fair burden. The findings have informed about the degree of "quasi-voluntary compliance" of street traders as taxpayers. Everest-Phillips and Sandall (2008: 3–4) argue that the idea of quasi-voluntary compliance extends the concept of legitimacy from both the intrinsic and instrumental willingness to pay tax based on taxpayers' overall perception of the fairness of the tax system. At the instrumental level, taxpayers assess the government's capacity to deliver on the fiscal social contract, that is, the instrumental side of governance in providing essential public goods such as security and core services such as infrastructure, health, and education. At the intrinsic level, taxpayers' perceptions of the legitimacy of the state, called tax morale, combines political acceptance of state authority, the perceived fairness and effectiveness of state institutions, and trust in public institutions and officials. Everest-Phillips and Sandall (2008: 3) noted that "tax compliance is low in developing countries where citizens neither believe governments act in their interest, nor trust the state to use revenues wisely."

This research shows that the implementation of the local taxation system in Indonesia is still weak and there is a gap between the actual and potential revenues. This is partially influenced by the low level of tax morale due to the lack of local governments' capacity and legitimacy as perceived by street traders. Informal trading operators as citizens tend to avoid paying tax to a state they do not believe in. The more legitimate a state is in the eyes of its citizens, the higher the citizens' tax morale. This leakage of revenue is likely to occur not only due to the lack of administrative capacity of local tax levied and the vulnerable mechanism of financial monitoring and planning at local level, but also due to the scope of abuse in administering the tax collection, especially due to fraud by tax collectors as stated elsewhere. Lewis (2006) indicates corruption related to local taxation has become more than "public secret" under Indonesian decentralization.

The question then is: what strategies can be used to deal with such opportunities and challenges? In terms of increasing local taxation from street enterprises, the issue of regulation and formalization is central here, whereby formalization or regulation depends on the nature and characteristics of the informal economy in that particular region. It is clear that informal enterprises, even large ones, choose to stay that way if there is no change in the factors that generally drive them into informality, such as high corporate taxes and the bureaucratic burden of operating formally.

Therefore, the strategies that can be developed should take into account the question of why those involved in street trading are informal? First, is the factor related to the margins of profitability of the informal sector, which are so small that regulation means the destruction of the activity itself? In this is the case, then regulation in the way that it applies to formal establishments may not be suitably applied to those in the informal businesses. Regulation and tax will lead to economic distortions caused through undesirable disincentives. Second, if the factor has something to do with the procedures and practices of formalization of the trading that are often overly difficult, then formalization can be selected as a strategy to deal with the informal economy.

In the case of street traders in Jakarta and Bandung, the second scenario is closer to the findings. The capacity and willingness of street traders in Jakarta and Bandung are relatively high and viable for local taxation. Therefore one policy option that can be applied is the formalization of street traders through a review of the regulatory processes. It is argued that once the regulations and procedures are relaxed and improved, street traders will almost automatically follow the formalization of their business activities, including formal taxation. Discussions with resource persons and seminar participants as well as interviews with government officials in Jakarta and Bandung lead to a number of recommendations to support such policy options. In order to effectively and efficiently apply local taxation into the street trading, four options merit attention:

1. Taxation of the informal economy is possible and viable in terms of economic and legal concerns, especially to those operating their business in fixed and appointed locations. It needs to take into account the characteristics, typology, and economic scale of the trading. For example, user charges may be higher to those businesses operating in attractive locations and obtaining high revenues.
2. Jakarta and Bandung have already Perda (local regulations) related to the collection of user charges. However, the regulation is only a part of the Perda on cleanliness, orderliness, and attractiveness based on paradigm of a "security" rather than an "equality" approach. Therefore, regulating local taxation of the street traders needs specific Perda using a new approach under the paradigm of good governance. In terms of user charges, it also needs to be clearly stated that the fees collected will be associated with specific government services.
3. It is clearly noted that the main issue is that the charges are not being collected and accounted for properly, so that the informal sector is being burdened

without the municipality benefiting. In addition, the capacity and legitimacy of local governments in managing the tax are low. The improvement of good governance, including the enhancement of government officials' commitment and administrative capacity are highly needed.

4. The collection of tax or user charges could involve street traders' associations, especially in collecting fees on a daily basis. Capacity building of such associations is required to improve their skills and commitments in doing such tasks. This idea was proposed by a few participants of the workshop so as to maintain the effectiveness and efficiency of tax collection. It is argued that instead of taking money one by one from street vendors, tax collectors can collect money faster through the association.

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ANNEX

1. Research Methodology

1.1 The Design

This research-for-policy project employed the triangulation method. This mixed-research approach refers to a combination of strategies to study the same phenomenon employing quantitative and qualitative techniques of data collection. As identified by Greene, Caracelli, and Graham (1989), the purpose of the triangulation method is particularly to seek convergence, corroboration, and correspondence of results from the different research strategies. This method leads to more confidence in the results and generates an innovative approach to the study of social issues. Whilst this project is flexible and cyclical, the method of data collection is operationalized under four main activities as summarized in Table 2.7.

Table 2.7
Matrix of Data Collection

Methods and steps	Purposes and main information collected	Timeline
1. Desk review	▪ Achieving research objective No. 1 ▪ Significance of local tax from street enterprises	November–December 2008
2. Seminar and focus group discussions	▪ Achieving research objective Nos. 1 and 3 ▪ Significance of local tax from street enterprises ▪ The impacts of taxation and equity effects on the informal economy	First week of December 2008
3. Fieldwork	▪ Achieving research objective Nos. 2, 3, and 4 ▪ Explore the characteristics of street enterprises ▪ Perceptions towards the practice of tax/user charge collections ▪ Practical difficulties and the scope of abuse in administering the tax collection	January and March 2009
4. Workshop	▪ Informing and refining research findings ▪ Generating policy alternatives and advocacy plan	Fourth week of June 2009

1.1.1 Desk Review

This activity is aimed at collecting secondary data through desk review of literature and related documents (e.g., previous research reports, newspapers). The information collected was focused on macro/national level data on local government revenue sources by type, disaggregated by tax/revenue instrument, and disaggregated by type of local government. This activity is on-going, yet the main findings were collected in December 2008.

1.1.2 Seminar and Focused Group Discussions (FGDs)

To complement and support the desk review, a one-day seminar and focus group discussions were held at the Bandung College of Social Welfare. Two experts (Mr. Teguh Kurniawan, Senior Lecturer from the Department of Public Administration, University of Indonesia, Jakarta, and Ms. Resmi Setia, Senior Researcher, AKATIGA Research Foundation, Bandung) who have expertise in local taxation and the informal economy served as the resource persons. This seminar was attended by 24 participants consisting of lecturers and postgraduate students from the Bandung College of Social Welfare; Pasundan University, Bandung; and the Bogor Institute of Agriculture as well as representatives from street vendors' associations, the municipal governments of Jakarta and Bandung (i.e., Board of City Development Planning and Office of Social Affairs), NGOs, and the mass media (Pikiran Rakyat Daily, Bandung; Gala Media Daily, Bandung; and Media Indonesia Daily, Jakarta). This activity was held on January 21, 2009.

Following the seminar and panel discussions, focus group discussions were held with the participants to delineate the possible impact of local taxation and equity effects on the informal economy. Whilst information about macro/national level data on local government revenue sources was explored further, the significance of the informal economy to local economic development was also discussed through the focus group discussions. In addition, information about the opportunities and challenges of taxing the street vendors in Bandung and Jakarta was also delineated in this event. With three facilitators (the author of this report and two lecturers of the Bandung College of Social Welfare), focus group discussions were organized into three small groups. Each group has one spokesperson and rapporteur.

1.1.3 Fieldwork

Fieldwork was employed to obtain primary data and information about characteristics of street enterprises in Jakarta and Bandung. This activity was directed to identify the enterprise structures, and the economic and demographic profiles of the informal economy so as to understand its capacity and willingness to pay tax. Primary data were obtained from questionnaires and in-depth interviews applied to selected participants of street traders, tax collectors, and related public policymakers from the Bandung Municipality and South Jakarta jurisdictions. Fieldwork was completed between January and February 2009. A preliminary report was completed on March and was presented in the second workshop of LGI (interim team workshop) on April 24–30, 2009 in Istanbul.

Jakarta and Bandung cover a large area in terms of the total area and number of street enterprises. As the capital of Indonesia, Jakarta is administratively a province consisting of five territories or municipalities, namely, Jakarta Pusat (Central Jakarta), Jakarta Utara (North Jakarta), Jakarta Barat (West Jakarta), Jakarta Selatan (South Jakarta), and Jakarta Timur (East Jakarta). Bandung is the capital of West Java province situated 180 kilometers southeast of Jakarta. Administratively, Bandung encompasses two regions, known as Greater Bandung or Bandung Raya: the district (kabupaten) and the municipality (kotamadya). The municipality covers the metropolitan core of Bandung City, whilst the district covers the area surrounding the municipality area. In 2007, the total population in Jakarta (five municipalities) and Bandung (district and municipality) was estimated at 8.5 million and 5.4 million people, respectively (CBS 2008).

The selection of particular locations in each city was based on the agglomeration (concentration) of the street enterprises within the subdistrict area of Bandung Municipality and South Jakarta areas. Because the number of street traders is very large and concentrated in various locations of the city, a certain number of participants was selected as samples of the population in a certain site within the given subdistrict area. Preliminary observations were initiated in each city to examine those research locations characterized by the most agglomerated and highest number of street enterprises (i.e., market areas with malls, supermarkets, business complexes, and crossroads that are full of pedestrians), and determine the locations for data collection.

In Bandung, 105 participants were selected from two sites at the Simpang Market and Kosambi Market areas, where about 97 and 133 street traders are located, respectively. In Jakarta, data collection was concentrated in South Jakarta and involved 135 participants selected from about 350 street vendors in Pasar Minggu or Sunday Market. The selection of research participants mainly used a purposive sampling technique in order to get reliable information from different groups of respondents. The socioeconomic backgrounds, such as types of informal activities, revenues, level of authority in public policymaking, and gender characteristics were taken into account to achieve as much as possible a representative sample of respondents. In order to approach such a number of participants effectively and efficiently, this data collection was assisted by six junior data collectors.

1.1.4 Workshop

In addition to the desk review, seminar, and fieldwork, this project also included a one-day workshop involving a wide range of policymakers and policy stakeholders. The workshop was conducted on the fourth week of June 2009. This activity was aimed particularly at informing and improving initial findings and generating initial policy alternatives. The workshop was conducted with a participatory approach and a framework involving a number of policy stakeholders, such as street traders' associations, NGO workers, members of professional associations, and selected leaders and members of community organizations.

Local Taxation and the Informal Sector in Pakistan

Increasing Local Government Revenues in the Faisalabad and Sukkur Districts of Pakistan

Mosharraf Zaidi and *Saad Paracha*

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EXECUTIVE SUMMARY

Pakistan's informal sector has grown at an unprecedented pace over the years, and today 72.9 percent of the non-agriculture workforce is employed by this sector. There has been a significant growth in the informal sector over many years and the issue has become a matter of great concern, with government considering proposals to bring the informal sector into the mainstream economy through a number of initiatives. According to conservative estimates, out of a USD 140 billion economy, well over USD 32 billion is in the informal sector, providing huge opportunities for its businesspeople to evade and avoid taxation every year.

This study, one of the very few on the subject in Pakistan, analyzes local taxation in economies that are predominantly informal by looking at four tehsils in two provinces of Pakistan. Reviewing own source revenues, key levies, and the associated socio-cultural, political, and administrative issues, the study provides recommendations for local and provincial governments to improve revenue generation in an inclusive and efficient manner.

The specific objectives of the study are to assess local government revenues in selected areas of Pakistan to:

- understand their status in general and vis-à-vis the informal economy in particular
- find the constraints to and potential for improvement
- discuss and recommend policy options for improving local government revenues.

The first section of the report provides a brief discussion of the nature of the informal economy in Pakistan. This is followed by sections that provide a brief overview of the local government system and its finances. Section 4 looks at the sources of revenue in detail along with the collection trends in the focus municipalities in the Faisalabad and Sukkur districts of Pakistan. The final section looks at options for reforms and their feasibility and concludes with some recommendations.

The report identifies the significant dependence of the local governments on federal and provincial transfers. The local governments work under expenditure restrictions especially in terms of those relating to personnel. Their independence is further compromised as the hiring and firing authority rests mostly with the provincial governments. The report also identifies the duplication of tax authority resulting in an increase in compliance costs for taxpayers and leads to spatial variation in effective tax rates, with associated distortions. It also has been observed that the taxes allowed by various levels of the district government are not buoyant enough to yield good returns. Local governments represent elite classes rather than the population as a whole, and ultimately emerge as custodians of class-specific interests. Taxes are resented and generally considered as encroachment by the state on the finances of the people, pointing to a deficit in real, sustainable trust. The report also analyzes specific levies like the transfer of immoveable property tax, property tax, and advertisement tax to identify the detailed problems and their potential.

The report concludes with a discussion of three sets of policy options namely the status quo; the tweaking; and the upheaval options, with supporting detailed recommendations on improving analysis/collection functions, undertaking tax rate revisions, and consolidation of tax code in an incremental manner.

1. INTRODUCTION

A study conducted by the Lahore University of Management Sciences in 2003 showed that out of PKR 100 due in tax revenue, the government receives only PKR 38 and PKR 62 is pocketed by the taxpayer, tax collector, and tax lawyer. It means that of the total of PKR 720 billion collected in tax in 2005–06, only 38 percent of about PKR 2 trillion was actually collected by the Federal Board of Revenue.[2] According to the draft of Pakistan's National Employment Policy,[3] the informal sector has grown at an unprecedented pace over the years, and today 72.9 percent of the non-agriculture workforce is employed by this sector. There has been a significant growth in the informal sector over many years and the issue has become a matter of great concern, with government considering proposals to bring the informal sector into the mainstream through a number of initiatives. According to conservative estimates, out of a USD 140 billion economy, over USD 32 billion is in the informal sector, providing a huge opportunity for Pakistan's businessmen to evade taxes every year.

While these estimates look at federal revenues, there has been no overall assessment of tax evasion or revenue potential at the local government levels in Pakistan where revenue generation also takes place. Local governments, already operating in a hostile policy environment, with high constraints on access to adequate human resources and limited macro-political support for decentralization, are further weakened by almost total financial dependence on provincial and national governments. This low autonomy can somewhat be offset by higher "own source" revenues. A fair policy debate in Pakistan on decentralization requires as assessment of local governments, not simply as fiscal sinks that drain provincial and national governments of power and prestige—but rather as units of government with some degree of autonomy that enable and assist federal and provincial governments in delivering a minimum standard and coverage of public services and assure appropriate accountability.

The purpose of this study is to examine the revenue realities and the potential for improvement among four of Pakistan's local governments, including both rural and urban areas in two of the four provinces. A key contextual consideration is that the revenue and expenditure assignments operate within economies that are predominantly informal. The analysis here is restricted to local governments, with a focus on *Tehsil* Municipal Administration (TMAs). TMAs are responsible for providing major municipal functions and also have the authority to generate a major chunk of resources, as compared to the other two tiers of local government in Pakistan, namely district and *union*. *Union* is the lowest tier in the local government structure in Pakistan. The analysis takes into account the revenue sources and their nature, their respective yield over the past years, and makes an effort to identify the challenges and opportunities to enhance local revenues in economies that are predominantly informal.

The specific objectives of the study are to assess local government revenues in selected areas of Pakistan to:

- Understand their status in general and vis-à-vis the informal economy in particular;
- Find the constraints to and potential for improvement;
- Discuss and recommend policy options for improving local government revenues.

The first section of the report provides a brief discussion of the nature of informal economy in Pakistan. This is followed by sections that provide a brief overview of the local government system and its finances. Section 4 looks at the sources of revenue in detail along with the collection trends in the focus municipalities in the Faisalabad and Sukkur districts of Pakistan. The final section looks at options for reforms and their feasibility and concludes with some recommendations.

2. METHODOLOGY

The following instruments and methods have been used in finalizing this study:

- Desk review of literature and past reports;
- Field data collection from the local governments under focus and subsequent analysis;
- Focus group discussions, interviews, and consultations with stakeholders including local government officials, tax authorities, and the business community.

3. THE INFORMAL ECONOMY IN PAKISTAN

The informal sector or informal economy is defined in a variety of ways. Some of the terms applied to the informal sector include the unobserved economy, the unregulated sector, and the underground economy, which also refers to illegal activities as well. For example, Braun and Loayza (World Bank 1994) describe the informal economy as a set of economic units that do not comply with government-imposed taxes and regulations but whose product is considered as legal. Others have stressed the exclusion from the taxation net as a defining characteristic of informality (Joshi and Ayee 2008). Various reasons cited for the inclusion of the informal sector consist of the need for increasing revenues, while also providing opportunities for businesses to expand. The informal sector cannot borrow or rely on the legal system to execute and ensure contracts and resolve disputes.

The informal sector in Pakistan is formulated in terms of household enterprises (Labor Force Survey 2006–07) and the size of employment. For statistical purposes, the provenance of employment in the informal sector is given as follows:

- All household enterprises owned and operated by self-employed workers irrespective of the size of the enterprise (informal self-employed enterprises);
- Enterprises owned and operated by employers with less than 10 persons engaged. It includes the owner(s) of the enterprise, the contributing family workers, the employees, whether employed on an occasional or a continuous basis, or as apprentices,
- All enterprises engaged in agricultural activities or wholly engaged in non-market production are excluded.

The informal sector consists of small units producing goods or services with the primary objective of generating employment and incomes to the families engaged in these activities. Informal activities have often been characterized by low levels of capital and skills, poor access to organized markets and technologies, low and unstable incomes, and poor and unpredictable working conditions. Such activities are often outside the scope and purview of the official statistics and government regulations as well as beyond the formal system of social protection. The units operating in the informal sector are highly labor intensive but employment is mostly casual and based on kinship and personal relations rather than contractual arrangements ensuring protection. The informal sector activities depend, to a large extent, on the local and regional demand. Despite its growing size, the informal sector continues to be largely "invisible" and "neglected." Sufficient information is lacking concerning employment patterns, the nature and extent of its activities, and the characteristics of its participants. This leads to an absence of information on regional trade and any activity-specific employment potential.

Various methods have been used to estimate the extent of informal economy in Pakistan. The Labor Force Survey of 2006–07 estimates that the informal sector accounts for 72 percent of the employment in the forms of employment outside the agriculture sector, more in rural (73 percent) than urban areas (71 percent). Kemal (2007), using different methods, estimates the size of underground economy at 31–64 percent of GDP. He also estimates that tax evasion as a percentage of GDP ranging between 3.8 to eight percent of GDP. The fact that Pakistan's budget deficit is between three to seven percent of GDP signifies the importance of this tax evasion. He, however, includes illegal activities like smuggling, black marketeering, etc., as part of the underground economy. Gennari (2004) estimates the contribution of the informal sector to the GDP using the Labor Force Survey definition and data. He criticizes the non-inclusion of criterion of registration of the enterprise by the Survey and some aspects related to data accuracy. But the work provides interesting insights into the nature of informal sector in Pakistan. For example, the study shows that the contribution of the informal sector to total value added is substantial in wholesale and retail trade, and hotels and restaurants, accounting for over half of the total value added to the industry, and that is also substantial in transport and communications as well as in the social, community, and personal services sectors.

There have also been recent efforts in estimating the "tax gap" for Pakistan (Ahmed and Rider 2008 and World Bank 2009). The federal tax gap in Pakistan for 2007–08 is estimated to be about 79 percent of actual tax receipts. Other studies have focused on the revenue potential of provincial governments (Government of North Western Frontier Province and Malik 2004; Bahl, Wallace, and Cyan 2008) to employ various methods to come up with estimates of the potential for the urban immovable property tax, motor vehicle tax, agricultural income tax, and taxes on professions, trades, and callings. The missing link, however, in these studies is that of the informal sector.

There have been very few efforts in estimating the potential of local government revenues in Pakistan (Decentralization Support Program, Government of Pakistan 2005 and CIDA 2007). These studies have mostly focused on federal and provincial revenues. All these efforts have not taken into account the informal sector as such and mostly relied on estimating the higher potential for taxation by proposing higher tax rates, improved administration, and documentation. All these elements, however, can be successful in formal settings and where economies are well documented. Still, it has been found that many of the businesses operating at the local level invariably pay various local fees even if they are not paying, or are evading, some of federal and provincial taxes.

The discussion on local taxes and levies in this study does not depend on any scientific or agreed upon definition of what constitutes "formal" or "informal." Nevertheless, while avoiding turning the focus of this study to characteristics of the informal sector in Pakistan, we have primarily looked at two explanations about the informal sector. According to the World Bank, the informal sector covers a wide range of labor market activities[4] that combine two groups of a very different nature. On the one hand, the informal sector is formed by the coping behavior of individuals and families in an economic environment where earning opportunities are scarce (casual jobs, temporary jobs, unpaid jobs, subsistence agriculture, moonlighting). On the other hand, the informal sector is a product of rational behavior of entrepreneurs that desire to escape state regulations. The latter includes unofficial business activities, tax evasion, avoidance of labor regulations and other government or institutional regulations, and is characterized by the non-registration of companies. This category also includes underground activities like crime and corruption—activities not registered by statistical offices.

The Aspen Institute's Microenterprise Fund for Innovation, Effectiveness, Learning and Dissemination (FIELD) has worked for many years to educate policymakers about microenterprise as anti-poverty strategy. The Microenterprise in US project,[6] provides the following four characteristics that are associated with an informal economy. We find these characteristics to be in play in the districts in the focus of this study on Pakistan:

- They involve licit but unregulated work: enterprises, employers, and self-employed individuals do not comply with standard business practices, taxation regulations, and/or other business reporting requirements, but they are otherwise not engaged in overtly criminal activity.
- They include both employed and self-employed workers, with some engaged in both kinds of work.
- Cash is the most common medium of exchange, although bartering also occurs.
- Work conditions for those who labor are inferior to those found in the formal economy.

The entities that operate in the informal economy, as per this categorization, display the following characteristics:

- They are largely invisible or operate at low levels of visibility. They may or may not have licenses, are often engaged in casual hiring, non-reporting of income, and other informal labor practices. They can be easily moved, opened, or closed at will, and thus, can hide from regulation.
- They pursue businesses similar in type to those commonly found among all microentrepreneurs, and most focus on very local markets.
- Like other microentrepreneurs, many are income patchers; that is, they engage in multiple economic activities to generate a living.
- They generate low revenues and have very few assets.

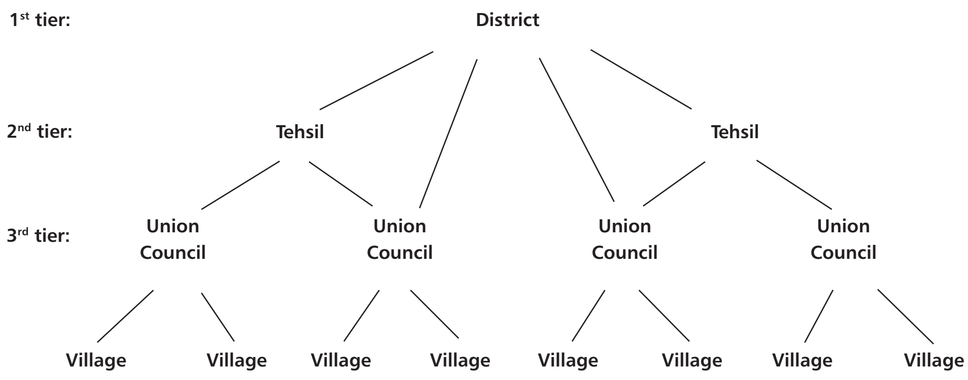
4. THE LOCAL GOVERNMENT SYSTEM IN PAKISTAN[6]

Pakistan has a federal administrative structure guided by the Constitution of Pakistan of 1973, with amendments. The Parliament consists of the National Assembly and the Senate. The allocation of functions of the federal government and the provincial governments is specified by the Constitution, the former having the authority to make laws with respect to any matter in the Federal Legislative List and the latter in the Concurrent Legislative List. However, in case of a dispute between the two, the writ of federal government shall prevail, hence providing for the root of centralization in Pakistan. While local governments have always been a part of the conceived structure of the federation, their status, shape, and form falls entirely under the domain of the provinces. Local government reforms in 2001 were accompanied by a special constitutional provision allowing a time-limited protection[7] for local government law enacted by the provinces. Prior to 2001, the Constitution of Pakistan did not fully recognize local governments as a separate tier of government with their own powers and functions. They were essentially viewed as extensions of the provincial governments, having been created by provincial legislation, through which some functions were delegated to them.

Pakistan has a poor track record of democracy, since for more than half of its years of existence after independence it has been ruled by the military. While the military governments always have found faults with the politicians, it was always they who created the local government systems. Pakistan has experimented with two systems of local government before the introduction of the current system in 2001. The history of local governments in Pakistan is characterized by two factors: first, the local governments have never been autonomously functional in the presence of democratic governments. Second, every time a new system of local government is created, it is at the expense of the previous system.

In 2001, Pakistan simultaneously promulgated four provincial Local Government Ordinances establishing a new structure and system of governance at the local level. It is imperative to point out that these laws, although a product of some consultations, came about when no elected government existed at the provincial level. This, in our view, was a critical missing link in ensuring ownership for the new system. The new law has established a uniform three-tier structure comprising of a district, tehsil and union throughout the country irrespective of the size or other features of the various locations. This major change was also introduced in one stroke without piloting the system anywhere. The district remains the largest unit of the system and geographically comprises of tehsils and unions. Tehsils are called towns in large city districts and talukas in Sindh Province. Direct elections are held only at the union level, whereby these directly elected councilors form the Electoral College for other tiers of the local government. Each tier comprises of a respective council led by a nazim (mayor) and naib nazim (deputy mayor), and administration headed by district coordination officer (DCO), *tehsil* municipal officer (TMO), and union secretaries. Two elections have been held since the new law of 2001.

Figure 3.1
Local Government in Pakistan



Source: National Reconstruction Bureau, Government of Pakistan.

5. LOCAL GOVERNMENT FINANCES[8]

Public finances in Pakistan have been characterized by high fiscal deficits, poor revenue mobilization, a persistent trend of centralization, massive vertical imbalances between federal and provincial governments (i.e., very large gaps between provincial governments' expenditures and own revenues, which have to be made up by the means of fiscal transfers from the federal government), weak financial management, and a lack of accountability by the public sector (World Bank 2000). Local governments have not been recognized by the Constitution as a separate tier of government and have existed only as extensions of the provinces, with some functions delegated to them by the provinces. This has seriously affected the fiscal structure and related distribution of authority for revenue mobilization and expenditure obligations among different levels of government.

Each of the ***local government tiers*** has been assigned specific responsibilities and revenue raising authority in accordance with the Local Government Ordinance of 2001. While each district differs in size and resources, the responsibilities and revenue raising authorities remain uniform as per the law. Respective councils are authorized to approve budgets and can also approve changes in the rates of respective authorities.

Expenditure assignments are specified in the First Schedule of the Local Government Ordinance of 2001. There are certain legal and operational overlaps between the provincial and local governments in this regard. This is mainly due to the dependence of the local governments on provincial transfers and the fact that there are vertical development programs funded by federal and provincial governments. Most social services fall under the domain of the local governments. At the national level, the separation of responsibilities and jurisdictions are specified in the Constitution of Pakistan through a Federal Legislative and Concurrent List. The Concurrent List identifies areas where provinces have jurisdiction. The actual expenditure assignments at the local government level, therefore, also vary with each provincial government and their desire to exercise control or delegate responsibilities to the local governments.

Revenue assignments are specified in the Second Schedule of the Local Government Ordinance of 2001. In general, most of the high-yielding tax authorities rest with the federal and then provincial governments. The revenue generating opportunities for various tiers of local governments remain minimal and cumbersome. The following table summarizes these assignments.

Local Revenue Administration. The district governments, in accordance with the Local Government Ordinance of 2001, can levy, assess, and collect taxes with the approval of the respective elected councils. In reality, however, the extent to which this authority is exercised varies with the location and resources of the districts and also within the three tiers of the local government. As mentioned above, each tier has a separate set of revenues to generate. Each tier has a different set of administration to deal with these matters. At the district level, the executive district officer (EDO) of finance and planning heads the finance department and is assisted by district officers (DOs) and other support staff. At the *tehsil* level the functions are performed by the tehsil municipal officer (finance and revenue) supported by lower cadre staff.

Table 3.1
Sources of Local Revenue[9]

District councils	Tehsil and town councils	Union councils
▪ Education tax ▪ Health tax ▪ Tax on vehicles other than motor vehicles ▪ Local rate on lands assessable to land revenue ▪ Fees in respect of schools, colleges, and health facilities established or maintained by the district government ▪ Fees for licenses granted by the district government ▪ Fees for specific services rendered by a district government ▪ Collection charges for recovery of tax on behalf of the government as prescribed ▪ Tolls on new roads, bridges, within the limits of a district, other than national and provincial highways and roads	▪ Local tax on services ▪ Tax on the transfer of immovable property ▪ Property tax on annual rental value of buildings and lands ▪ Fees on advertisements, other than on radio and television, and billboards ▪ Fees for fairs, agricultural shows, cattle fairs, industrial exhibitions, tournaments and other public events. ▪ Fees for approval of building plans and construction and reconstruction of buildings. ▪ Fees for licenses or permits and penalties or fines for violation of the licensing rules ▪ Charges for execution and maintenance of works of public utility like lighting of public places, drainage, conservancy, and water supply ▪ Fee on cinemas, theatrical shows, and tickets thereof, and other entertainment ▪ Collection charges for recovery of any tax on behalf of the government, district government, union administration or any statutory authority as prescribed.	▪ Fees for licensing of professions and vocations ▪ Fee on sale of animals in cattle markets ▪ Market fees ▪ Fees for certification of births, marriages, and deaths ▪ Charges for specific services rendered by the union council ▪ Rate for the remuneration of village and neighborhood guards ▪ Rate for the execution or maintenance of any work of public utility like lighting of public places, drainage, conservancy, and water supply

The tax or revenue administration also differs between districts and *tehsils*. The district tier mostly relies on the local offices of the provincial Excise and Taxation Department (provincial taxes including property tax) and the Board of Revenue (provincial land revenue, mutation (Mutation of property is the recording in the revenue records the transfer of title of a property from one person to another) and registration fee, agricultural income tax). Their own capacity to administer local taxes is generally weak, with few staff, and those they have are not trained to manage the levies available under the new law.

Tehsil governments have generally better own source revenues than the district, even though they too are dependent on transfers from higher levels of the government (provincial and federal). *Tehsils* collect the urban immovable property tax and many other kinds of fees and levies. Many of these collections are through contractors, and therefore there is a huge scope for improving the capacity of tehsils to manage revenues including taxes. For the taxes and levies under their jurisdiction, they have a fair degree of independence to set the tax rates, their assessment and collection. Various procedures and processes for the key levies are discussed below.

Key Taxes/Fees/Levies and their Business Processes.[10] The following table describes the general processes associated with some of the key levies at the *tehsil*, town, and *taluka* level.

Table 3.2
Tehsil, Town, and *Taluka* Levies

No.	Name of tax/fee/levy	Business processes	Basis
1.	**Transfer of Immovable Property Tax**	This tax is collected at the time of execution of a sale deed or at the time of verification of mutation. The TMA staff assesses levies and collects the tax from buyers of immovable property. The process is supervised and controlled by a contractor in some cases. Salaries of TMA staff responsible for collection are also paid by the contractor, who pays the bid amount to a designated TMA account. The contract is given on a yearly basis. EDO (revenue) registers firms that wish to participate in the bidding. The bids are presented in the council and contract is awarded after an open competition. If no contract is awarded, TMA staff performs the assessment, levy, and collection function under supervision of the TMA.	One percent of the value of property as recorded in the sale deed/registry.
2.	**Advertisements/ Billboards fee**	Collection is either auctioned or undertaken directly by the local governments themselves (different in various *tehsils*).	Based on various rates prescribed for different sizes of billboards levied on an annual basis.

Table 3.2 (Continued)

No.	Name of tax/fee/levy	Business processes	Basis
3.	**House Tax/ Property Tax**	The tax is assessed and collected by the Excise and Taxation staff from the owner of the house. There are certain exemptions, e.g., for widows and for retired armed forces personnel. Moreover, there is no house tax on houses measuring 5 *marla* or less (25 feet by 50 feet). Demand notices are created on a yearly basis and issued to the owner of the house, who pays the amount into a designated bank account.	Based on rates notified for different sizes of land/ property levied on an annual basis.
4.	**The *bazari* (encroachment) fee**	The *bazari* clerk issues receipts for encroachments and deposits the received sums in accounts branch.	Levied on encroachers on land (a certain amount per square foot and hand cart owners).
5.	**Slaughter fee**	Auction/direct recovery by TMA staff	Rate prescribed per animal type.
6.	**Copying fee**	Those needing an official certified copy of any document apply to the competent authority, who may decide to grant such certified copy on payment of the fee determined by the TMA. The clerk concerned recovers the copying fee. The copying fee is nominal, but three to four times the prescribed fee is charged from the applicant. Not all of this extra fee is deposited in TMA accounts.	Rate prescribed per copy.
7.	***Bakar Mandi* (cattle market) fee**	Auction/self-recovery. The contractor organizes the sale/purchase of animals at designated places. For this service, he charges a fee as determined by the TMA.	Fee prescribed per animal.
8.	**License fee**	The TMA staff issues licenses to persons providing professional services, e.g., butchers, milk sellers, and other trades. A fee is charged for the issuance of such licenses. This is the fee charged from professionals providing services within the jurisdiction of a TMA. The license fee is determined by the TMA and levied through a notification in the official gazette. The renewal is on an annual basis against payment of a fee.	Rate notified for each profession or trade.

Table 3.2 (Continued)

No.	Name of tax/fee/levy	Business processes	Basis
9.	**Building fee**	Departmental recovery. Anyone who wishes to construct a house must get the building plan and architectural design approved by the TMA. The building fee is charged for such approval.	Fees prescribed for residential, commercial, industrial buildings as per their size.
10.	**Shop Rent**	Recovery by TMA staff from tenants.	Rent as agreed with tenants.

General Issues

- ***Dependency on Federal/Provincial Transfers:*** Given the nature of public finances in Pakistan, the local governments are still dependent on the provincial and federal governments for many reasons. So long as provincial governments keep on posting their employees to the local levels, this dependency is unlikely to change. In addition, provinces still exercise substantial control over the budget preparation process of the district governments. The TMAs do not play any active role in legislation (e.g., bylaws) and exist as extensions of federal and provincial governments (master-client relationship).
- ***Expenditure Restrictions on Districts and Tehsils***: The districts have many restrictions, especially in terms of personnel-related expenditures. They are not authorized to hire the required human resources. However, a positive departure from the past is that they do not have to go back to the provincial governments for those projects where they have their own resources for funding. But the districts, at present, do not have much maneuverability with the development budget as a very large percentage of the total budget still goes to non-development expenditures like salaries.
- ***Revenues:*** There are many cases where there is a duplication of tax authority between the provinces and districts. Property tax is one such example. Overlapping tax bases or tax base sharing between different levels of government increases compliance costs for taxpayers and leads to spatial variation in effective tax rates, with associated distortions. It is further observed that the taxes allowed by various levels of the district government are not buoyant enough to yield good returns. A major problem with regard to revenues is that many urban areas generate more revenues than rural or undeveloped areas. While part of this problem is addressed by the equalization grants from the provinces, it still leads to dependency of these areas further out in the provinces. The generation of resources at the level of TMA clashes with vested interests which explains under-taxation, nontaxation, and evasion.

- ***Audit and Accounting Issues:*** After the 2008 elections, the newly elected provincial governments severely criticized the delays in the holding of annual audits by the local governments. The law stipulates establishment of internal audit functions but these have not been institutionalized after a lapse of so many years.
- ***Representation:*** District and TMA members represent elite classes rather than the population as a whole, and ultimately emerge as custodians of class-specific interests. Ownership of executive functions does not exist at a grass-roots level. Taxes are resented and generally considered as encroachment by the state on the finances of the people, pointing to a trust deficit.

6. LOCAL REVENUES IN FAISALABAD AND SUKKUR DISTRICTS[11]

Faisalabad

The Faisalabad District, originally called Lyallpur, is the third largest city in Pakistan, and is a key district of the Punjab Province of Pakistan. The name Lyallpur was derived from one of the foremost colonists of the British Raj, Sir James Lyall, who served as lieutenant governor of the Punjab. The lower Chenab Canal is the main source of irrigation water, and helps meet the requirements of 80 percent of the land cultivated in the district. The district represents among the more cultivable agricultural regions in the province, with fertile soil and easy access to water. The key attraction of Faisalabad as a location for rural migrants has been the city's world-renowned textiles industry (cotton-based fabrics). Faisalabad's exports (to mainly North American and European markets) alone account for nearly 40 percent of Pakistani exports. There are over five hundred large industrial units, the vast majority of which produces textiles. Engineering, chemical, and food processing industries have also benefited from the advantages Faisalabad offers to large-scale industrial enterprises. Much smaller industries also have a history of thriving in the district, and there are also some 12,000 household industries, which include some 60,000 power loom factories.

The City District Government of Faisalabad, established in 2005, concurrently with the introduction of amendments to the Punjab Local Government Ordinance of 2001, consists of the towns (municipalities) of Lyallpur, Madina, Jinnah, Iqbal, Samundri, Tandianwala, Jaranwala, and Chak Jhumra. Faisalabad district covers an area of nearly six thousand square kilometers. Estimates for the population of the district vary between six and seven million, and for the city area of Faisalabad, between three and four million. The literacy rates in Faisalabad have tended to be lower than in other large cities of the country.

For the purpose of this study, Lyallpur (population: 1,545,190; 57 unions) and Jaranwala (population 861,482; 38 unions) were selected for their urban and peri-urban nature. Both the towns have thriving commercial, industrial, and informal activities. The industrial sector in these towns has indirect, rather than direct ramifications. The local economies rely on the jobs and opportunities for business created by the industrial activity in the district—but both towns represent the typical feeder localities from which management and lower management staff local industries, as well as being the source of some demand for the industry's products. The implications of these characteristics are that the informal economy in these towns benefits from, but is not directly dependent on, the industrial complexes that characterize Faisalabad, at a macro-level.

Sukkur[12]

Sukkur District is located in Sindh Province, on the banks of the Indus River. While it is the third major urban center in the province, after Karachi and Hyderbabad, it is primarily rural in character, and therefore is comprised of what are called talukas—representing the trraditional municipality model in the province of Sindh. Talukas date back to the earliest settlements in Sindh Province, and enabled conquering armies and colonists to administer the extraction of natural and human resources from the region. With four talukas (municipalities), Sukkur district covers an area of 5,165 square kilometers and has a population of about one million. The district's economy relies primarily on the agricultural activity of its surrounding districts, and that primary agricultural activity supports a range of industrial activity in Sukkur, including cotton ginning, silk and food processing, rice and flour milling, textile dyeing, metal works, boatbuilding, tanning, tobacco processing, shad fishing, and the manufacture of chemicals, cement, candy, tiles, hosiery, and playing cards. The scale of industry in Sukkur is modest, particularly in comparison to Faisalabad, and the consumption of Sukkur-produced goods is almost exclusively domestic, and particularly local. Land fertility and productivity have traditionally been quite good in Sukkur; however, recent years have seen a degradation in the quality of water available to the land, via the Indus River, and productivity has been reduced considerably as a result. Sukkur's main crops include rice, cotton, tomatoes, peas, wheat, barley, chickpeas, melons, and dates, and the district is host to a number of riverine forests.

For the purpose of this study, the Sukkur City (population 560,000) and Rohri (population 310,851) municipalities were selected for their urban and peri-urban nature. Both the towns have a robust local economy with a vibrant commercial sector.

7. NATURE OF TAXES, THEIR YIELD, AND ADMINISTRATION

This section makes an attempt to provide the basic data for local revenues in Pakistani local governments. Table 3.3 provides a brief description of each of the taxes, fees, and charges levied at the town, tehsil, and/or taluka level. The basis, rates, and administration of the key levies are provided in following table. The actual yield of the key levies for each tehsil is also provided. The approach adopted by our study to review various sources of revenues in the informal sector takes into account the peculiar characteristics of the informal sector in Pakistan. Our observations on the ground, interaction with the stakeholders, and review of the revenue sources and data indicate that a significant portion of revenues is generated by informal economic activity and that the informal sector plays an important role in both income generation and job creation for the local economies we examined.

The situation observed in the focus areas is in line with the earlier discussion about the informal sector. Most of the observed business activities cannot be classified as illegal or criminal. The issue of registration is rather tricky as well. On one hand, much of the business activity is not registered under federal taxation system, but they cannot avoid paying many of the local government fees and taxes. A much more detailed analysis would be required to quantify and classify various enterprises in accordance with the above-mentioned characteristics of informal economies. For the purpose of our analysis, we find it extremely difficult to identify businesses that are informal in general, but not paying at least some of the local government levies. There may be cases of underpayment (immovable property tax), but in general the local government levies are hard for the informal businesses to avoid as we have observed. This provides an excellent opportunity to develop the local government financial administration to lure informal activities into the taxation net. Much of this activity remains out of the ambit of the federal taxation regime, especially direct taxes. In fact, the study leads us to conclude that local revenue generation is probably the most effective way to bring the informal activities under some sort of taxation net. If applied efficiently, local revenue generation can also pay for improving many of the services that fall under the ambit of local governments in Pakistan.

Table 3.3
Taxes and Their Description

No.	Tax, fee, or charge	Description	Basis and administration
1.	Tax on transfer of immovable property	Municipality receives 90 percent of this tax. Remaining 10 percent is received by district revenue office as they collect the property tax.	One percent of transfer value, imposed on buyer.
2.	Advertisement fee	Fee on billboards and other advertisement means developed inside the area of a municipality.	Various rates for different sizes of boards, imposed on advertisers on an annual basis.
3.	The bazari fee	Fee charged to people who run their businesses outside the existing shops, for example, a shoeshine service, photocopying, etc., outside a shop.	Various rates per square foot of encroached land/area imposed on the encroacher.
4.	Slaughter fee	Fee charged by slaughterhouses managed by the municipalities.	Certain fee per animal (e.g., PKR 50/cow) paid by slaughterer.
5.	Copying fee	Very small fee charged on copying, typing, and issuing documents in municipal administration offices.	PKR 10/page paid by the person requesting copy.
6.	Trade licensing fee	Around 60 different types of licenses listed under this category.	Various rates have been specified for different types of businesses.
7.	Building fee	Fee charged when construction plan for construction of a new building is approved.	Rates of approval of building plans are specified according to size and imposed on the owner.
8.	Shop rents	Applied on buildings constructed by the municipality.	Monthly rent as determined by the TMA and imposed on tenant.
9.	Ground rents	When *kachi abadi* (shelters, informal settlements) convert to *paki abadi* (formal, planned settlements), a certain amount is collected per month as ground rent.	PKR 1/yard (varies in different TMAs) imposed on land used.
10.	Sandal piri fee	Fee on cabins/shops developed by people to run small business (*Khokha dukan*).	Specified rate per square foot of shop/cabin imposed on the business.
11.	Cattle piri (grazing) fee	For cattle grazing, municipality provides separate ground; this fee is collected from those people who use this land for grazing.	Specified rate per animal imposed on the owner.
12.	Hand cart fee	Fee collected from those people who run their business using hand carts (*Rehri wala*).	Specified rate per cart imposed on the owner using TMA land.

Table 3.3 (continued)
Taxes and Their Description

No.	Tax, fee, or charge	Description	Basis and administration
13.	Latrine fee	Fee collected on those latrines constructed by municipality, fee collected either by municipality or by *theka* (contractor) system.	Various rates per person using the latrine.
14.	Parking fee	Fee charged on *raksha*, cycle, motorcycle, or any other vehicle on entrance into the municipality's parking area.	Specified rate per vehicle type (truck, trailer, taxi, car).
15.	**Misc. income**	Others not included.	

Evaluation of Own Source Revenues in the Focus TMAs

Table 3.4
Total Local Own Revenues (PKR Million)

	2005–2006	2006–2007	2007–2008	2008–09 (Estimate)
Rohri	8.1	15.0	21.3	26.0
Sukkur City	24.0	26.0	31.0	31.2
Lyallpur	131.0	137.2	106.0	133.0
Jaranwala	57.2	58.3	55.0	83.2

Rohri

Figure 3.2
Rohri Revenue Trends

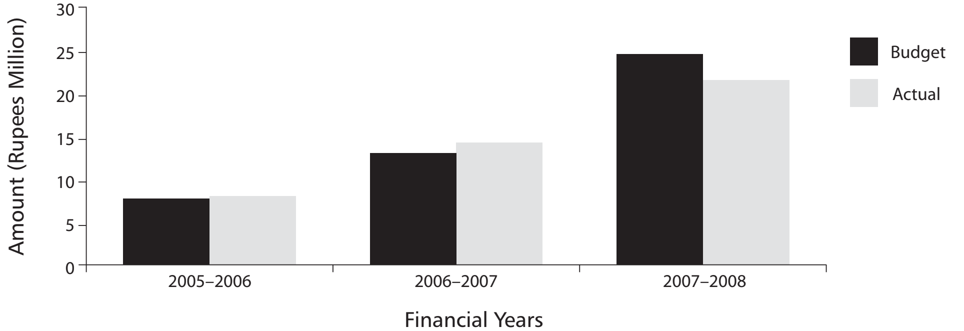


Table 3.5

Key Levies in Rohri (PKR Million)

Description	2005–06			2006–07			2007–08			Budget estimates
	Budget	Actual	Yield percent	Budget	Actual	Yield percent	Budget	Actual	Yield percent	2008–09
TAXES										
House tax	0.001	0.001	0.008	0.001	0.000	0.002	0.011	0.001	0.002	0.011
FEES										
Market fee	0.544	0.492	6.076	0.671	0.613	4.215	0.855	0.855	4.018	0.798
Slaughter fee	0.008	0.009	0.111	0.012	0.012	0.084	0.104	0.015	0.070	0.020
Copying fee	0.000	0.000	0.003	0.000	0.000	0.001	0.000	0.000	0.001	0.000
Fish market fee	0.020	0.015	0.179	0.015	0.017	0.116	0.019	0.015	0.070	0.019
Map approval fee	0.025	0.030	0.372	0.050	0.029	0.199	0.030	0.025	0.117	0.025
Income from town hall and parks	0.050	0.066	0.815	0.050	0.067	0.459	0.050	0.050	0.235	0.050
Property transfer fee TMA	0.002	0.002	0.020	0.001	0.001	0.004	0.001	0.001	0.005	0.001
Property tax by government	0.350	0.009	0.117	0.100	0.077	0.531	0.100	0.100	0.470	0.100
Property Reg: fee by sub registrar	0.065	0.109	1.352	0.030	0.097	0.666	0.050	0.350	1.645	0.350
Shop rentals	0.260	0.255	3.144	0.200	0.299	2.054	0.315	0.315	1.480	0.315
License fee	0.050	0.047	0.578	0.100	0.084	0.578	0.200	0.650	3.055	0.400
Cattle *piri* fee	4.975	4.975	61.447	6.615	4.987	34.289	7.900	7.600	35.717	8.047
Market fee of Kandhra	0.080	0.117	1.445	0.278	0.235	1.618	0.274	0.274	1.288	0.315
Shop rentals in Kandhra	0.010	0.007	0.084	0.020	0.021	0.147	0.040	0.020	0.094	0.020
Slaughter: Stall fee of *Kandhra*	0.016	0.012	0.148	0.055	0.041	0.280	0.442	0.100	0.470	0.066

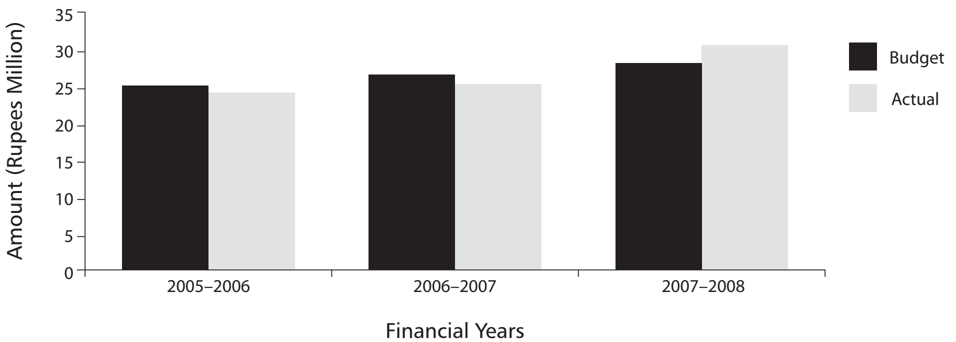
* *Yield*: as a proportion of total local government.

Main Observations

- In terms of yield, the most prominent levy appears to be the one collected from cattle grazing, given the peri-urban to rural and agricultural setting of the TMA.
- Various kinds of rents collected from markets are the other key levies in terms of yield.

Sukkur

Figure 3.3
Revenue Trends in Sukkur City



Main Observations

- In terms of yield, the most prominent levy is the one collected from property-related transactions given the urban setting of the TMA.
- Various kinds of rents collected from markets are the other key levies in terms of yield.
- The other significant levy is collected from approval of building plans pointing to significant construction activity in the TMA.

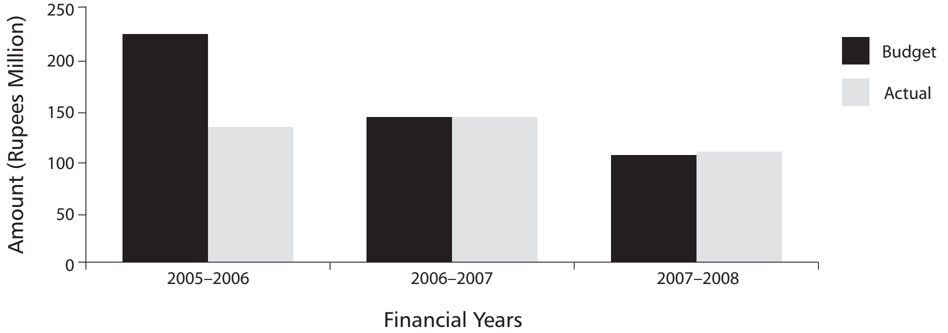
Table 3.6
Key Levies in Sukkur City (PKR Million)

	2005–06			2006–07			2007–08			2008–09
	Budget	**Actual**	**Yield percent**	**Budget**	**Actual**	**Yield percent**	**Budget**	**Actual**	**Yield percent**	**Budget**
TAXES										
Property tax	14.500	14.000	58.237	15.000	14.700	61.149	15.000	16.600	69.053	15.000
Charge on registration of property	2.000	2.100	8.736	2.100	2.300	9.568	2.500	2.450	10.192	2.000
FEES AND CHARGES										
Sadal piri fee	0.588	0.417	1.735	0.588	0.410	1.706	0.600	0.488	2.030	1.000
Cattle *piri* fee	0.100	0.092	0.383	0.600	0.600	2.496	0.650	0.650	2.704	0.750
Advertisement fee	0.288	0.255	1.061	0.296	0.287	1.194	0.438	0.422	1.755	1.400
The *bazari* (*rezki*) fee	0.320	0.320	1.331	0.365	0.365	1.518	0.420	0.420	1.747	0.750
Slaughter fee	0.112	0.112	0.466	0.140	0.140	0.582	0.150	0.150	0.624	0.150
Copying fee	0.003	0.003	0.011	0.004	0.003	0.014	0.005	0.004	0.016	0.004
Building fee (*naqsha* approval)	2.000	1.897	7.891	2.200	2.000	8.320	2.500	3.800	15.807	4.000
Trade license fee	—	—		—	—		—	—		7.000
Shop rentals	5.000	4.500	18.719	5.500	4.700	19.551	5.500	5.100	21.215	5.500
Ground rent (*Paka pati*)	0.127	0.029	0.121	0.127	0.033	0.137	0.127	0.036	0.149	0.125

* *Yield*: as a proportion of total local government revenues.

Lyallpur

Figure 3.4
Revenue Trends in Lyallpur



Main Observations

- In terms of yield, the most prominent levy is the one collected from property-related transactions given the urban setting of the TMA.
- The other significant levy is collected from approval of building plans pointing to significant construction activity in the TMA.
- Other key levies are trade licenses and advertisements

Table 3.7

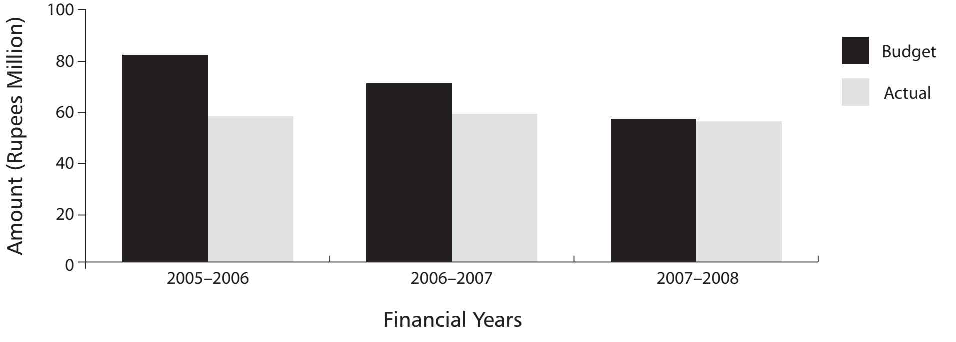
Key Levies in Lyallpur (PKR Million)

	2005–06			2006–07			2007–08			2008–09
	Budget	**Actual**	**Yield percent**	**Budget**	**Actual**	**Yield percent**	**Budget**	**Actual**	**Yield percent**	**Budget**
LOCAL TAXES										
Property tax	70.000	—	0	60.000	59.786	45.138	24.968	24.968	18.850	45.000
Charge on registration of property	85.000	95.784	72	58.050	58.162	43.912	58.872	58.872	44.448	60.050
FEES AND CHARGES										
Sandal piri fee			0			0.000			0.000	
Cattle *piri* fee	0.075	0.066	0.049	0.400	0.000		0.178	0.230		0.550
Advertisement fee	30.000	4.612	3.482	Tax transferred to City District Government						
The *bazari* (*rezki*) fee	0.400	0.049	0.037				—	0.516	0.390	—
Slaughter fee	5.015	2.597	1.961	0.675	0.898	0.678	1.549	1.549	1.170	2.500
Copying fee	0.200	0.053	0.040	0.005	—	0.000	0.007	0.007	0.005	0.005
Building fee (*naqsha* approval)	15.700	15.911	12.013	8.400	8.437	6.370	8.500	8.577	6.476	9.500
Trade license fee	6.000	3.625	2.737	1.700	1.025	0.774	1.758	1.758	1.327	2.000
Shop rentals	1.805	1.805	1.363	1.391	1.391	1.050	2.250	2.250	1.699	2.825
Ground rent (*Paka pati*)	0.282	0.282	0.213	0.310	0.310	0.234	0.001	0.001	0.000	1.688

* *Yield*: as a proportion of total local government revenue.

Jaranwala

Figure 3.5
Revenue Trends in Jaranwala



Main Observations

- In terms of yield, the most prominent levy is the one collected from property-related transactions.
- Various kinds of rents collected from markets, building plan approvals, and parking fees are the other key levies in terms of yield.

Table 3.8

Key Levies in Jaranwala (PKR Million)

	2005–06			2006–07			2007–08			2008–09
	Budget	Actual	Yield* percent	Budget	Actual	Yield percent	Budget	Actual	Yield percent	Budget
LOCAL TAXES										
Property tax	22.416	2.415	4.222	7.000	6.799	11.885	8.581	8.581	15.000	10.000
Charge on registration of property	37.108	35.744	62.486	40.600	29.331	51.276	25.100	25.756	45.025	49.057
FEES AND CHARGES										
Bakar Mandi	2.451	0.947	1.655	2.060	1.647	2.880	2.022	2.022	3.535	0.203
Cattle *piri* fee	0.902	0.852	1.490	1.300	1.027	1.795	0.976	1.296	2.266	0.975
Latrine fee	0.069	0.048	0.085	0.060	0.055	0.095	0.063	0.054	0.094	0.053
Advertisement fee	0.209	0.209	0.365	0.030	0.028	0.049	0.009	0.009	0.015	—
Parking fee wagon, ricksha, tonga, and taxi stand	6.669	5.345	9.344	7.181	7.415	12.963	9.670	7.905	13.818	8.876
The *bazari* (*rezki*) fee	0.547	0.553	0.967	0.825	0.561	0.981	0.515	0.515	0.900	1.040
Slaughter fee	0.494	0.422	0.737	0.525	0.425	0.744	0.510	0.460	0.805	0.462
Copying fee	0.050	0.045	0.079	0.060	0.053	0.092	0.035	0.035	0.061	0.050
Building fee (*naqsha* approval)	7.875	7.259	12.689	5.000	6.171	10.789	4.589	4.589	8.022	7.500
Trade license fee	1.414	1.292	2.259	1.873	1.628	2.846	1.026	1.026	1.793	1.500
Shop rentals and ground rent (paka pati)	2.121	2.071	3.620	3.575	3.113	5.441	2.825	2.825	4.939	3.500

* *Yield*: as a proportion of total local government revenue.

The sources of revenue display an interesting consistency across the TMAs under review. Property-related levies including sales, transfers, and construction remain the predominant levy. The only exception is Rohri where, surprisingly, the maximum yield comes from cattle grazing. A deeper look into the quality of grazing services being provided could provide leads to maximize the yield from this levy.

Cost of Collection

In order to get a rough idea about the cost of collection, a detailed review of staffing and associated costs was undertaken for the *taluka* in Sukkur City as part of the study. Out of many offices at the *taluka* level, the following offices were found to be directly or closely associated with administering own source revenues. Given the culture and human resource practices at this level, multitasking is common and the following, even at best, presents just a rough estimate based on interviews and available records. The offices dealing with water and drainage-related charges have been deliberately excluded from the focus of the study. It is interesting to point out that while the local governments were denied the collection of *octroi* tax (tax imposed on goods brought for consumption into a administrative unit/district) since 1999 and provided a lump sum share from the sales tax in lieu thereof, Sukkur City continues to maintain an office for the purpose. According to their budget documents, the *octroi* department has 103 sanctioned staff positions, out of which 89 are vacant. However, the staff are indicated in the budget. This anomaly was not clearly explained by the staff. Our study excludes the octroi department for its visible absence from the revenue collection and the fact that the sanctioned staff is not available/recruited.

Table 3.9
Octroi Staff in Sukkur City

Department	Sanctioned staff	Vacant positions	Budget allocation (PKR million)
Finance department	15	3	12.0
Regulation department	4	4	0.4
Tax branch	57	22	7.0
Cattle corral	3	1	0.4
Land grant branch	16	7	1.7
Infrastructure department (excluding women's hostel)	56	36	7.3
Total	151	73	28.1

Sukkur City's actual collection for the 2007–08 is PKR 30.5 million, hence putting the cost of collection at about 90 percent of the revenue generated. This obviously appears to be very high as very little is left over for revenues for development expenditures in the taluka. This, however, tallies with the general situation of revenues and expenditure at local government levels in Pakistan where established costs (salaries, etc.) account for more than 80 percent of the local budgets. Another striking feature is the high percentage (almost 50 percent) of vacant positions at the local level. The reason, in most cases including Sukkur, is a ban on the recruitment of staff. The local governments continue to budget for them for the fear of losing sanctioned posts, making the whole budget-making exercise unrealistic. In fact, this points to problems in budget management and capacity issues at local levels. The budgeted expenditure lapses at the end of the fiscal year and the positions for which the amounts were allocated remain unfilled. Discounting the unfilled positions from the cost of collection brings down the collection cost to 45–50 percent, which is still very substantial (and would be higher still if the octroi department were included). There is a serious need to review the budget-making process and revenue collection practices at the local and provincial levels.

Box 3.1
Revenue Potential in the Khanewal TMA

Revenue Potential in TMA Khanewal*

A Revenue Potential Survey of TMA Khanewal was conducted in 2005 involving a door-to-door census for water rates, license fees on professions/vocations, and billboard taxes. The exercise indicated a revenue increase potential of 71 percent and 94 percent for professional fees and billboard taxes, respectively. The study could not identify any potential to increase revenues from water rates due to outdated records and poor service quality. The potential was calculated by identifying new payees and a new rationalization of the rates. Poor market information, poor record maintenance, and a lack of monitoring capabilities were identified as the main weaknesses.

* (AHNR Consulting for Decentralization Support Program, Government of Pakistan 2005)

Potential for Corruption and Evasion

The anthropology behind informal taxes is important to consider. The system is open to quite widespread and significant opportunities for rent-seeking, largely due to limited record-keeping, manual ledger record-keeping, and the very low levels of literacy and legal awareness among entrepreneurs. This is made worse by the disincentive for local governments to raise their own revenues given the significant injections of vertical funds from the provincial and federal governments. These transfers are both a systemic part of the local government revenue structure and performance, and need-based grants are made under specific, often politically motivated, direct interventions of a vertical nature by individual, group, and state entities located at the federal level. Specifically in the context of the focus areas of this study, one major area of underreporting/fraud, with some evidence of collusion, was observed in the case of the transfer of immovable property tax. This is because people underreport the actual market value of the property at the time of registration, and hence the tax that should be paid is avoided. This results in a number of revenue losses in the form of stamp duties and revenue coming to the local governments. The losses are significant, as per the views of local government officials, especially in urban areas.

Another key levy with significant actual collusion is advertisements (e.g., billboards). Instead of auctioning profitable sites, local governments rent out sites to applicants. Significant discretion is available to the local governments since areas are not surveyed and clearly categorized in terms of value. Due to limited monitoring ability, additional losses are incurred from illegal billboards as well. Whether they are really "illegal" or just exist with the connivance of local officials is debatable. Some of the other levies on encroachers are clearly open to exploitation, and hence the loss of revenue and the creation of an unfriendly business environment.

8. STAKEHOLDER PERSPECTIVE

A series of consultations were held with the officials of the local governments and local business community. The most critical one was held in Faisalabad with the *Anjuman-i-Tajiran* (Traders Association) of the city of Faisalabad. It was heavily attended, with participation from a number of other business associations like the electronics dealers association and the cloth merchants association, to name a few. Lively participation and debate was observed with both sides making their cases in a forceful manner.

The perspective of the local governments is summarized as follows:

- Abolishing many low-yielding taxes;
- Identifying the most promising targets for the property tax, provided some improvements can be made like regular updating of valuation tables as per market trends, and amending the Law of Preemption to apply to urban areas, etc.;
- Creating more realistic budget/revenue targets in the *tehsils*;
- Identifying collusion and evasion in the collection of key taxes (transfer of immovable property tax and advertisement/billboards fees);

- Reconsidering the transfer of most highly yielding taxes to the city district government, advertisements in the case of Faisalabad;
- Loosening strong provincial controls, and eliminating delays in transfers of funds due to the *tehsils* as their share of the taxes collected on their behalf by higher tiers of the government (mostly provincial taxes);
- Improving weak management capacity and poor enforcement.

Unlike the common perception, the study found a large variety of businesses, vocations, and professions at the local levels, almost all of which were paying one or another form of levy. The other interesting observation was that many of the businesses did not appear to be under the ambit of direct federal taxes. The nature of provincial taxes (e.g., motor vehicle registration) is such that all businesses, irrespective of their type, could not evade it. Each TMA had an elaborate list of professions/vocations and fees assigned for those practicing these vocations. The business community complained about the high-handedness of contractors, the unequal rates applied to the same professions in adjoining TMAs, and the disproportionate and discretionary increase in different rates. One obvious problem was the disconnect, and resulting lack of trust, between the local government and business community.

The perspective of the local business communities is summarized as follows:

- No visible benefit for paying taxes;
- Poor services by the local governments and their selected contractors, and weak monitoring by the tehsil governments;
- No accountability of elected officials, staff, and contractors;
- Varying tax rates causing confusion, especially in the case of professions tax;
- Unclear jurisdictions and incidences of multiple tehsils claiming the same tax or fee (e.g., goldsmiths in adjoining towns of Faisalabad complained about the different rates charged);
- Willingness to pay taxes, and even higher rates of tax, if the number of taxes is reduced, and if effective management and results can be demonstrated;
- Willingness to pay more in return for simplified procedures and improved services.

9. PRINCIPAL OBSERVATIONS

Some of our overall findings resonate with those identified by a similar study focusing on the districts of Kasur and Lodhran (CIDA and COWATER 2005). These include:

- Legal confusion/lacuna cause loss of revenue;
- Local governments have limited autonomy to set their own tax rates;
- There is limited possibility of introducing new taxes/rates/fees;
- There is vast potential to improve collection efficiency as the present system of assessments is not professional and is not based on any surveys or data;
- Refining business processes can increase own source revenue;
- Improvement in service delivery is a prerequisite for increasing user charges;
- Comprehensive mapping and development of databases can broaden the tax base;
- Certain taxes/fees can be abolished with negligible Own Source Revenue (OSR) loss;
- Weak tax administrative (assessment, collection etc) points to significant capacity gaps at the local level;
- Tax collection targets are arbitrarily fixed and frequently missed but without fixation of responsibility;
- Non-professional officials tasked with the collection responsibilities;
- No transparency in assessment and collection;
- Inability to expand the tax base has resulted in taxing the already taxed sources of revenue with all the three tiers sharing the pie (e.g., each property transaction involves stamp duty, registration fee (provincial tax), TMA tax, and capital value tax (federal tax);
- Loopholes in laws relating to conversion of agricultural land into residential/ commercial land allow people to mint money at the expense of the state.

10. OBSERVATIONS ON SPECIFIC LEVIES[13]

Transfer of Immovable Property Tax

This is one of the most important sources of revenue for a TMA. The rate of this tax was until recently five percent, later reduced to two percent and now fixed at only one percent of the value of property (Punjab). It was hoped that lower tax rates would persuade people to correctly report property values and pay due tax. This is generally not the case. Since the property value is generally underreported in the sale deed/registry, TMAs cannot realize the tax even at this reduced rate of one percent. Recovery should be based on valuation tables and not on the basis of the recorded sale price. The valuation tables, where available, should be revised regularly, preferably every three years; the last time the valuation table was revised was some five years ago. The District Officer (DO) (revenue at the district level) revises the valuation table after a survey of property prices. This power (i.e., the determination of valuation table) should be given to TMAs as the tax is assessed, levied, and collected by the TMAs. DO (revenue) has little to do with the tax, except settling the property value in the valuation table. For revision of the valuation tables, services of professional private sector firms should be engaged. If the valuation table is revised upwards regularly, the provincial government will also benefit in terms of enhanced recovery of stamp duty. Generally, there is intense competition among contractors for the collection rights of this tax. Through a recent amendment, it has been made possible for a contractor registered anywhere to bid for the contract. This allows for greater competition in the awarding of contracts. This is essentially a gamble. Property prices are highly variable. Sometimes there are very few actual sales, on account of, for example, an anticipated property price hike. In such cases, the contractor might even abandon the contract midway. This tax has the maximum potential for yielding higher yields.

Advertising and Billboards Fees

This fee is for various kinds of boards and banners, most significant of which are the billboards. Fees levied on billboards falls under the purview of the provincial government. This forms a major source of revenue for *tehsils* and especially those with an urban population. In cases where districts have been converted to city districts, the same has been transferred from the *tehsils* to districts, hence causing a major loss of revenue for *tehsils* (Faisalabad is a case in point). The fee has the potential to be an important revenue source for the TMAs. Proper surveys should be conducted to collect data about number of boards in the territorial limits of the TMAs as, at present, the record is incomplete. It is proposed that surveys should be outsourced to the private sector due to the lack of trained staff within the TMAs. The survey can also identify critical/high visibility areas that could then be auctioned to generate the maximum revenue for the TMAs. At present some areas have been rented out at very low prices. Rates also need to be rationalized at regular intervals.

House Tax/Property Tax

Section 117 of the Punjab and Sindh Local Government Ordinances both declare a *tehsil* or town as a rating area and the TMA is authorized to determine the rate of property tax (commonly called house tax) within its territorial limits. There is considerable confusion in the assessment and collection of this tax, however (the local government versus the provincial excise and taxation department). The legal confusion notwithstanding, in practice, the tax is collected by excise and taxation staff at the district level and deposited in Account 1, which goes to the provincial government. The local governments/*tehsils* are then authorized to keep a certain portion of the collected amounts. This either does not happen or in some cases the transfers are substantially delayed. The confusion needs to be clarified and clear processes need to be established so that the TMAs can get their share of this important levy.

Slaughter Fee

Presently this is being collected by TMA staff. Considerable leakage exists in the collection of this fee. According to rough estimates, around 70 percent of animal slaughter takes place outside the designated slaughterhouses. This not only leads to the erosion of the TMA's legitimate income, but also effectively undermines any efforts at quality control and food safety. At the same time, the facilities provided by the TMA at the slaughter houses are inadequate and the clients do not feel obliged to pay these fees on these grounds.

Copying Fee

The amount received as a copying fee is too little. The citizens pay far more than what actually reaches the TMA coffers. With the promulgation of Freedom of Information Ordinance, more people should have access to public documents, and to facilitate this the charges should be clearly displayed and accounted for. Otherwise, the charges could be abolished without much loss to the TMAs.

Bakar Mandi (Cattle Market)

The contractor organizes the sale/purchase of animals at designated places. For this service, he charges a fee as determined by the TMA. There is a need to establish more markets for the sale and purchase of animals. Also, the contractors should provide better facilities at such places. The monitoring of mandis (markets) by the TMA staff is poor and the traders complain about poor facilities.

License Fee

Considerable confusion prevails on the jurisdiction issue. The Licensing of Professions and Vocation Rules of 2002 does not clearly demarcate if the district government, TMA, or union council has the jurisdiction for the levy and collection of the fee. Hence, there are instances of multiple taxation. Practically, whosoever arrives first would collect the fee. There is no proper survey of persons providing professional services. In the absence of such a database, it is very difficult for the TMA to collect license renewal fees from every person liable to pay such a fee. The TMAs reviewed under this study have elaborate lists of trades and professions with taxes. If properly applied, this could generate sufficient revenue from the informal sector.

Building Fee

This is an important source of revenue, given the large size of construction activity in the TMAs' limits, especially those that are urban. The fee also plays a control role, allowing the TMA to ensure that building bylaws are followed. There are, however, a number of issues involved in this. First, the building fee is levied on and charged against buildings in the city. The rural areas, where a lot of construction activity goes on, are so far exempt from payment of such fee. They should be brought in the ambit through a decision by the TMA. Second, enforcement is poor and any financial deterrent is seldom administered to those violating the building code. In fact, the encroachment fee provision in the TMAs provides a convenient window for regularization of any violation of the building codes.

Shop Rentals

If the shops' rents are fixed at the current market rates and recovery is unaffected, this can be a very important source of revenue for the TMA. Unfortunately, however, the shop rental fees remains at abysmally low levels. The archaic legal system, rent legislation, and rampant corruption in the lower judiciary effectively thwart any effort at rate enhancement. As per law, the rent can be increased up to a maximum of 10 percent every year or 25 percent after every three years. This is done, but the market far surpasses any such increase. Consequently, property worth millions is rented out at nominal rates. Under an informal transfer system (the *pugri* system), shops are transferred from one owner/tenant to the other at a *pugri* of millions of PKR. The TMA, however, gets nothing out of such transfers.

11. POLICY OPTIONS

The following options make an attempt to address the issues and problems discussed in the sections above, while reviewing specific levies and other circumstances in the tehsils in focus. To avoid duplication, not all specific recommendations have been repeated. Since the study focused on four tehsils in two provinces and the rules and procedures remain more or less similar, it was deemed appropriate to come up with somewhat generic policy options. This will allow these recommendations to be applicable to tehsils in both the provinces and helpful in improving own source revenues in economies that are predominantly informal.

The Status Quo Option

Maintaining the status quo in terms of the local government taxation regime is a viable option for Pakistan's provinces—the subnational entities under whom local governments operate. To appreciate why doing nothing represents a viable option, one needs to trace the positioning of the issue of subsidiarity within Pakistan's historical and political context.

Provincial governments, according to the Constitution, are representative and largely autonomous bodies whose participation in the Pakistani federation is a voluntary and mutually beneficial arrangement. The real politik of Pakistan's history, the difficult territorial issues it faces on all its borders (India, Afghanistan, and Iran), and the tradition of military intervention in political life has created a counter-subsidiarity strain within Pakistani governance. The centralizing impact of the insecurity of Pakistan's military and defense establishment is one of the primary drivers of the debate on decentralization.

Ironically, military governments tend to be keen to decentralize provincial powers to local bodies, while centralizing other provincial powers to the federal government. The impact of this dual pressure on provinces has created a counter-decentralization narrative among Pakistan's provincial politicians, the civil service at large, and among some members of Pakistani policy community.

Within this context, the option of maintaining the status quo and doing nothing with regards to the revenue generation potential and capacity of local governments, particularly as it relates to the informal sector, is an attractive option. The reason for this is rather simple: changes to the local government revenue system, particularly if they are deliberately fashioned to capture the informal economy, would involve altering the minutia and details of local government in Pakistan. That represents a highly risky, politically unstable choice, given that the overarching context and framework of devolution and decentralization is undecided. In the absence of a minimum level of consensus or collectively bargained agreement about the future of local governance in Pakistan, changes to the local government revenue system would be akin to changing the wheels on a car that has no engine.

Even if we were to suspend disbelief about the overarching context of decentralization in Pakistan, and examine the issue of local government taxation as it relates to the informal sector, some would continue to argue for a do-nothing approach. The reasons for this can be found in the analysis of who constitutes the informal sector's taxpayer, and who such constituents represent politically. Informal activity in almost all of Pakistan's cities and villages (save perhaps the metropolitan areas of Lahore and Karachi) is conducted by landless, asset-less, and uneducated citizens. While these citizens have almost no real voice in Pakistan's decision-making, they do carry one significant asset. Their ability to vote is a very significant factor in Pakistani electoral politics. One of the small mercies that the political elite confers to this class of informal sector actors is to protect them from the taxation net. Taxes in Pakistan have almost always fallen to either large corporations or to the urban middle class (which is exclusively engaged in formal activity). Doing anything to alter and improve local revenue from the informal sector therefore represents a politically infeasible option for decision-makers that have political interests in the local constituencies they represent.

On the whole therefore, doing nothing and maintaining the status quo is a viable and attractive option for overarching structural reasons, for macro-political economic reasons, and for local and grass-roots political reasons.

The Incremental Change or Tweaking Option

Despite serious political threats to the overarching structure of local governments at any given time in Pakistan, local bodies have almost always been part of the structure. The debate and fluctuation in Pakistan has always been about the relative levels of political, administrative, and fiscal powers of provinces and local bodies in the country. This means that regardless of the eventual outcome—or even in the likely case that a stable outcome continues to be elusive in terms of the status of local governments—local government finances, and particularly the magnitude and quality of their revenue generation, represent compelling policy issues.

If this premise is used to view the spectrum of policy options for local government taxation, particularly as it relates to the informal sector, there are essentially two choices. One is to begin to approach local government taxation issues in an iterative, sustained, and incremental manner, and the other is to engage in wholesale change that encompasses, structures, processes, and drives the outcomes of everything concurrently. The former represents the incremental change, or tweaking option, while the latter represents the transformational change option.

The argument for an incremental approach rests on three principal factors. First, incremental change allows reformers and agents of change to create small spaces and constituencies for change, without explicitly and boldly threatening the interests that tend to benefit from the status quo. In the case of the taxation system for local government, local officials' capacity for rent-seeking is enabled by the status quo. To change the system incrementally would mean exploring tactics that enable beneficiaries of the status quo to buy into a regime change, without directly threatening the employment of such officials.

Second, incremental change allows reformers to learn by doing, without toppling the entire edifice of existing systems and procedures. Incremental change, because it stretches out over longer periods of time, enables agents of change to learn on the go and adjust their solutions to problems in accordance with existing circumstances, be they political, social, or economic.

Finally, incremental change represents a lower level of political risk for reformers. When agents of change adopt incremental change as their mantra, there are few, if any, dramatic risks to their reputations. Failure or success while attempting incremental change has limited bearing on the direct or indirect political interests of reformers.

If decision-makers in Pakistan chose to adopt an incremental change approach to the local taxation of the informal sector, they would be best served by undertaking three specific measures to instigate reform.

First, they would need to invest in a dramatically improved data collection, storage, and analysis in relation to the informal actors in the economy, and their taxability. Second, they would need to make changes to the tax rates, many of which have not been changed in decades, and therefore reflect none of the changes that have taken place in the economy, class structures, and modes of production. Finally, they would need to invest time and effort in the consolidation of the tax code.

- *Database: Analysis/Collection Functions*
  The data available to local government officials on the informal sector activity is limited to those taxpayers that either voluntarily pay their taxes, or those that are surveyed by tax officials and choose to pay into the system, rather than bribing the officials. This means that the full potential for local taxation is an "X" factor in the debate on local revenue generation from the informal sector. To mobilize this "X" factor, local governments require a database that is updated regularly on the informal sector as a whole. (The data need for all local sources of revenue is high). Once collected through a survey that identifies baseline markers of the size, magnitude, and characteristics of the informal sector, a fully functional and updated database of informal economic activity will enable the policy community (decision-makers and citizens alike) to identify and locate the revenue potential of a given locality and to assess the skill and adroitness with which local officials collect may revenue. This database could also represent an accountability instrument—as long as there is a firm commitment to ensure a very high level of accessibility to citizens, e.g., through free Internet access to the database.
- *Tax Rate Revision*
  A particularly difficult element of the local taxation regime in Pakistan is the rates of tax that are imposed on firms and individuals. Local tax rates were originally set during the second half of the twentieth century by the pre-independence British Colonial Raj in what now constitutes Pakistan. In all cases, those tax rates have been revised very infrequently, with some tax rates not having seen any changes for decades. This static nature of tax rates has often meant that the currency and price inflation—especially in the case of flat-rate taxes—are in no way reflected in the local tax rates. Tax rates are not just out of date. They are, in many ways, out of synch and out of context. Changes in the economic, social, and political realities of Pakistan have translated into transformed economies, and indeed, local economies that vary significantly from each other, often, even within the same districts. To cater to these changes, Pakistani decision-makers

would be well served by altering the stasis on tax rates at the local level. A detailed analysis of each tax as it exists today and the kinds of considerations needed to be made in revising those taxes is available in sections 8.1 through 8.9 for nine of the major taxes levied by the local government.

- *Tax Code Consolidation*
  Finally, tax code consolidation—in synch with improved data collection and analysis, and better, sharper, more incisive tax rates that reflect the social and economic realities of present day local economies—will serve to buttress revenue generation, and modernize the edifice of local taxation of the informal economy in Pakistan. Consolidating the tax code will need to be undertaken with a view to both administrative considerations, and equity considerations. A high percentage of the levies, fees, rates, and charges at the local level are low-yield taxes. Additionally, these low-yield taxes only generate liabilities for small businesses that invariably tend to be members of the informal or marginally formal economy. Eliminating inefficient taxes, and lowering or reducing the tax burden on the poor, would be high-level policy outcomes from a serious effort to renegotiate and reconstitute the tax code. Formulating a roster of taxes that ensures greater revenues, without compromising on political and equity considerations, would therefore be an essential part of the incremental change option.

The Local Taxation System Transformation (or Upheaval) Option

From a purely analytical perspective of an academic or conceptual framework, the most attractive solution to the challenges faced by local taxation efforts and aspirations, specifically with regards to the informal economies of Pakistan, is a total transformation of a system that is outdated, inequitable, inefficient, and corrupt as well as being fiscally and politically irrelevant. The reform of the taxation system at the local level in Pakistan, of course, would be a very large undertaking requiring interest, effort, and commitment from a range of actors, beginning with political leadership in all three tiers of government (federal, provincial, and local). Chief among other key actors that will influence Pakistan's ability to affect transformational change in the local taxation regime will be bureaucrats, trade associations, chambers of commerce, and informal sector businesses. More incisive and more dramatic than incremental change, the upheaval or transformation option will require major changes in at least five specific and cross-tier areas, including the local government tax codes, the administrative structure of government at the provincial and local levels, economic and tax data at the provincial and local levels, and the service delivery paradigm, or more broadly the social contract that enables tax collection.

- *Transformation of the Local Government Tax Code*
  The local government tax code needs to be redefined for the 21st century. This redefinition would enable administrators to target high-yield sectors, including potential areas of opportunity in the informal arena, without being inequitable. A progressive local government tax code would attempt to ensure that both formal and informal economic actors that comprise low-income groups would pay no taxes, or very little taxes. Industrial production, for example could be taxed from an inputs perspective, making both formal and informal raw materials that contribute to manufacturing processes subject to taxes. The challenge would be to ensure that the burden of taxation is on the high capital, high income party—rather than low capital, low income actors.
- *Transformation of Administrative Structure*
  The civil service and administrative structures of local government – comprised of towns/tehsils/talukas as well as union councils and districts makes for an obfuscation of roles and confusion for taxpayers and citizens, in terms of identifying the locus of responsibility for the payment of taxes. Reforming the administrative structures to better reflect the balance between elected offices (at the union council level) and their responsibility to deliver services against income generated by tax and revenue sources (at the tehsil level) is therefore vital to improved tax regimes in local governments in Pakistan.
- *Transformation of Province and Local Government Relationship*
  As discussed elsewhere in this paper, provincial ownership of local governments and their fiscal issues is limited. Provincial governments, at least in last two years, have shown little commitment to see local governments become more independent in terms of resources. Improved commitment from the provinces would enable local governments to become more proactive and innovative in order to become less financially dependent on the provinces by enhancing their own revenues.
- *Transformation of the Data Regime*
  This would include, as stated in the incremental option, the entire range of data activities including collection, storage, archiving, analysis, and evaluation.
- *Transformation of Service Delivery Paradigm*
  Ultimately, an altered relationship between the state (at the local government level) and the citizen (and taxpayers) is central to the distinction that needs to be struck between tax collection for the sake of enriching the abstract, underperforming state—which is how many view local governments, and tax collection for the purpose of delivering services to the general public.

12. POLICY RECOMMENDATIONS

We recommend Pakistani decision-makers to adopt the Tweaking Option as the preferred choice of policy intervention to address the current challenges in local taxation of the informal economy.

Pakistan has a political landscape that is difficult for reformers to navigate in the best of times. Since 2007, Pakistan has been under a constant state of scrutiny by the international community, a sustained economic and fiscal crisis, and a political process, that has delivered a set of major and urgent constitutional amendments, without addressing the more immediate security and economic needs of the populace.

One of the key ingredients of better governance in Pakistan is a revenue system that produces locally autonomous resource allocation decisions. Such decisions are not possible without expanding the tax net.

This poses a clear dilemma for policy makers. Good public policy must deliver higher revenues to improve democratized and localized resource allocation decisions. Yet it must also do so without further deepening the set of political or economic challenges to the Pakistani state and incumbent government.

The tweaking option allows for a negotiated and phased approach to local taxation reform. Documentation of the economic activities at the local level is a long-standing challenge—which is often resisted by vested interests. By presenting the documentation exercise as an effort to ease the burden of taxes (through tax rate revision) and rationalize the targeting of taxes (through tax code consolidation), government could easily create a narrative of tax code reform that favors progressive taxation and distributive justice—both key populist considerations in a fragile democratic equilibrium.

One of the enduring complications in generating a national narrative, for what is a provincial (or sub-national issue), is the degree to which this process could be made subject to political manipulation. To prevent this, incentives could be offered by the federal government to the provinces to come to a cohesive and coherent outcome for the entire country.

Table 3.10
The Tweaking Option

Dimension	Ease of execution
Political	Easier than transformation
Fiscal	Easier than both transformation (high cost of reform) and do nothing (high cost of status quo)
Administrative	Easier than transformation
Replicability	Easier than both other options
Sustainability	Easier than transformation

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Local Taxation, the Informal Economy, and Local Government in Sierra Leone

Adams Tandorswefa Tommy

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EXECUTIVE SUMMARY

Over the years in Sierra Leone, formal direct taxation by local councils to finance the provision of local public goods has been quite limited, comprising less than 30 percent of the own source revenue profile of the councils. The low level of formal taxation would suggest that local public services are primarily financed outside the local community, either through direct provision, intergovernmental grants and contribution from other national and international NGOs.

To justify this claim, it is important to critically determine how local taxes are administered in the local economy, much of which is informal, the perception of stakeholders in the administration of the local taxes in terms of efficiency, effectiveness, and equity, and the burden placed on low-income informal traders from unofficial as well as official levies.

This study utilizes both primary and secondary data sources. Secondary data analysis looked at the extent and level of local taxation of the informal economy whilst the primary data analysis focused on stakeholders' (Mayors/Chairpersons, local council staff, business community, etc.) perception in local tax administration, the extent of service delivery, and the burden placed on low-income informal actors from official and unofficial levies.

The key findings of this study derived from both primary and secondary data analysis revealed that the assessments of some of the tax systems are invariably complex; there are the increased cost of collecting the local revenues, an excessive burden on taxpayers, and double taxation that resulted in resistance to pay, or taxpayers overburdened with all kind of taxes. The study has also revealed that tax collectors are often dishonest when accounting for local revenues from local residents or taxpayers who are underinformed and have mixed feelings of the kind of services provided.

This study recommends that Sierra Leone harmonize and rationalize the legal provisions and improve the administration of the already existing local own revenue sources. This could be achieved through:

- Investing in determining the revenue bases of the local taxes to have realistic estimates of their potential or more specifically, adapting the existing property tax and reforming business licensing;
- Contracting out the collection of some of the local revenue sources (market dues);
- Embarking on a national campaign to inform residents of the need to pay taxes, and the services that are to be provided in return;
- Strengthening the enforcement mechanisms on tax collection through establishing bylaws addressing penalties for tax defaulters and incentives for tax compliance;
- Reviewing and repealing the provisions in other legislation to be consistent with provisions in the Local Government Act of 2004;

- Ensuring that councils budget use at least 60 to 70 percent of local own revenues for direct service delivery before approval by the Local Government Finance Committee (LGFC);[1]
- Providing both demand- and supply-driven capacity-building programs for all local stakeholders including local government staff as an ongoing devolution process.

1. OVERVIEW

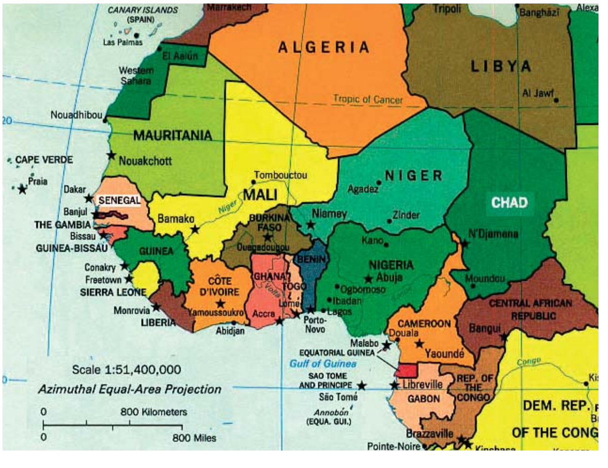
1.1 Research Focus

This study focuses on how far the administration of the local tax system captures the whole local economy (both formal and informal) and proposes suggestions for improving the administration and collection of these local taxes in terms of efficiency, effectiveness, and equity. The focus was on the major own source revenues administered by local councils as articulated in Section 45, Subsection 1 of the Local Government Act of April 2004 (LGA 2004). These local own revenue sources comprise: local tax, property rates, business licenses, fees and charges, and mining revenues.

1.2 Background Information on Sierra Leone and its Local Government Structure

Sierra Leone, located along the Atlantic coast of West Africa, shares borders with the Republic of Guinea, to the north and east, and the Republic of Liberia, to the south (see Figure 4.1). The country has an area of about 71,740 square kilometers and a population of about 6.1 million people.[2] The country is rich in mineral resources (diamonds, rutile, bauxite, etc.), yet 70 percent of the population lives below the income poverty line of less than one dollar per day (15 percent in Freetown and at least 79 percent in the rest of country).

Figure 4.1
Map of West Africa



Source: http://www.google.com/Map of Africa.

After independence in 1961, Sierra Leone's government began to deteriorate, which led to the abolition of local government in 1972. The centralization of power that resulted meant that the rural population was deprived of basic economic opportunities, education, and political participation. All these, coupled with widespread corruption, nepotism, and the marginalization of youths from decision-making, resulted in a bloody eleven-year (1991–2002) civil war that displaced half of the population, caused 20,000 deaths, and destroyed infrastructure and social capital.[3]

The government, after restoring peace and stability in 2002, undertook a series of institutional and structural reforms with the support of the World Bank, the International Monetary Fund (IMF), European Union (EU), the Department for International Development (DfID), the African Development Bank (AfDB), etc. Key among the reforms supported by these donors was the rebirth of government decentralization, which led to the enactment of the LGA in April 2004 that established 19 functional local councils. The LGA 2004 was supplemented by the Assumption of Regulations Act No.13 of November 2004 (the Statutory Instrument) that clearly mapped out the devolution[4] of functions to the local councils for the transition period 2004–2008.

The 19 local councils comprise five city councils, one municipality, and 13 district local councils including the Western Area Rural District Council (WARDC). Each district local council consists of, on average, 10 chiefdom councils. A chiefdom council is a tier of government below the local council that is legally obliged to collect certain revenues and share these with the local councils. Chiefdoms are further divided into sections and villages. The chiefs are hereditary rulers whose local powers have been assumed to largely supersede those of officials of the central and local government. They are constitutionally recognized and their influence remains important, particularly in matters of traditional culture and justice.

1.3 Sierra Leone's Informal Sector

Because of its very nature, the informal economy poses tremendous challenges to researchers attempting to estimate its size, and while they have attempted a variety of approaches, the measurement process remains an inexact science. For example, Feige (1979) declares all forms of measurement flawed in some way. Despite differences in the techniques and results, what clearly emerges from the data is the understanding that the informal economy is surprisingly large in most developing countries and Sierra Leone is no exception.

According to C. Magbailay Fyle,[5] the informal sector does not only serve the poor and low-income groups of the population but is patronized by all sectors of society. The International Labour Organization and Jobs and Skills Programme for Africa/JASPA (ILO) advisory employment mission report on Sierra Leone from

1990 described the activities in the informal sector as ranging from petty trading to carpentry, blacksmithing, tailoring, *gara* tie-dyeing, soap making, market women, palm wine tapping, small-scale construction, manufacture of basic tools and capital goods such as axes and hoes, local cement brick making, machinery, and other skill-intensive activities such as watch repair, motor, radio, and television repair, and diverse traditional financial intermediaries such as Rotating Savings and Credit Associations (ROSCAs), locally known as Osusu, and much more. This array of activities suggests that informal activities involve all sectors of the economy.

The actual size of Sierra Leone's informal sector could not be determined. However, the United Nations Capital Development Fund (UNCDF) report on the Development of a Sustainable Pro-Poor Financial Sector in Sierra Leone (2004–2009) estimated that the informal sector accounts for at least two-thirds of the 935,800 estimated number of households in Sierra Leone. A survey done by the Foreign Investment Advisory Service (FIAS) on Informal Economic Activity in 2005 estimated that at least 80 percent of all businesses operated in the informal sector. For the purpose of the survey, informality was defined as the lack of compliance with legal and procedural requirements for business operation.

Interviews with officials from government, including staff of the National Revenue Authority (NRA), also suggests that formal sector activities account for less than 30 percent of the local economy.

1.4 Problem Statements

A key function of local governments is the finance and provision of local public services. Over the years, the formal direct taxation of households in Sierra Leone has been limited, comprising less than 30 percent of local own revenues, for service provision. The low levels of formal taxation would suggest that local public goods are primarily financed outside the local community, either through direct provision, intergovernmental grants and contributions from other national and international NGOs. The reasons for this are partly attributed to ignorance or unwillingness of key stakeholders/institutions to meet their obligations and/or to adhere to the principles of decentralization and good governance. This is coupled with unclear provisions in the LGA of 2004 between local and chiefdom councils in revenue collection and sharing, inability of the central government through the ministry responsible for local government to fully meet its financial obligations in the form of subventions to chiefdoms, and conflicting regulations in the administration of central and local government revenues. More importantly, local councils lack the suitable local tax revenue instruments and do not properly collect the local revenue sources at their disposal as mandated by law and when they do, they find it hard to collect because much of the local economy is informal.

1.5 Objectives of the Study

The objective of the study is to answer the following questions:

- How are local taxes administered by local councils in the local economy, much of which is informal?
- What is the perception of stakeholders (officials from the NRA, local council officials, street traders' associations, ordinary citizens that pay local taxes and other levies, etc.) about the administration of local taxes, in terms of effectiveness, efficiency, and equity?
- What are the burdens placed on low-income informal traders from unofficial as well as official levies?
- What are the implications for policy? Are there specific government polices and/or regulations that might be adopted or changed that would make the chiefdoms more accountable, thereby ensuring a smooth revenue collection and sharing relationship between the local and chiefdom councils?

1.6 Limitations of the Study

Inasmuch as the research tried to address the efficient and effective administration of local taxes in the economy that is presumed to be largely informal, it did not focus on providing data on the size of informal economy in Sierra Leone. Descriptions of the characteristics and size of the informal sector in the context of Sierra Leone was presented through related research on the informal sector and discussions with stakeholders in government, the private sector, and enlightened ordinary citizens.

2. REVIEW OF RELEVANT STUDIES AND THE CURRENT STRUCTURE AND REFORMS IN LOCAL REVENUES ADMINISTRATION

2.1 Review of Relevant Studies

Various labels have been use by scholars to refer to the "informal economy." It has been called the irregular economy (Ferman and Ferman 1973), the subterranean economy (Gutmann 1977), the underground economy (Simon and Witte, 1982; Houston 1987), the black economy (Dilnot and Moris 1981), the shadow economy (Frey, Weck, and

Pommerehne 1982; Cassel and Cichy 1986), and the informal economy (McCrohan and Smith 1986). The popular media uses terms such as invisible, hidden, submerged, shadow, irregular, non-official, unrecorded, or clandestine (U.S. Department of Labor 1992). The common thread is that these activities are unrecorded or imperfectly reflected in official national accounting systems.

The informal sector is growing, absolutely and relatively. While the exact figures are debated, there is no doubt that the informalization of the economy is occurring in poorer countries. Recent calculations for developing countries suggest that the informal sector varies from between about 20 percent of GDP in Indonesia to around 67 percent in Bolivia; and that it accounts for over 40 percent of GDP in 24 out of the 55 countries for which estimates have been made (Alm and Martinez-Vasquez 2003).

Ironically, evidence suggests that the informal sector itself is not as averse to taxation as one might expect. Some research shows that tax evasion is not the leading reason for explaining the informal economy (Friedman et al. 2000). Avoiding costly regulation may be a more powerful motivation (Ngoi 1997; De Soto 1990). On the basis of survey data, Araujo-Bonjean and Chambas (2003) suggest that non-compliance in the informal sector often results from ignorance of tax legislation or the complexity of the tax system rather than from deliberate evasion.

2.2 Description and Administration of Local Revenues

Section 45, Subsection 4 of the LGA states that local councils shall make adequate efforts to collect revenues from their own sources that comprise: precepts from local tax; property taxes; licenses; fees and charges; shares of mining revenues; interests and dividends; and any other revenue due to the government but assigned to local councils by the minister responsible for finance by statutory instrument. Another very important revenue grant for the local councils that is not mentioned in the Act is the Local Government Development Grant (LGDG).

The LGDG program is a participatory, demand- and performance-driven program that commenced in 2004 and has been mainstreamed within the normal operational requirements of local councils under the LGA of 2004. The primary objective of the program is to make sure that all councils improve the provision of facilities and services for their people. The projects selected for funding under this program should be at the discretion of the local council, but must take the needs of local communities into account, preferably with consultations taking place at the Ward Committee level.[6]

The description and administration of each of the local own revenues are as follows:

2.2.1 Local Tax

Otherwise known as the poll tax, the local tax is a tax per head on selected individuals (at least 21 years of age and above). The taxpayers are not fully identified by either the local or chiefdom councils, so that a large proportion of the full tax potential is not actually collected. This is simply because of inadequate capacity (human and logistical) on the part of the collection agency (chiefdoms) to fully cover all areas within their respective jurisdictions. In instances where the chiefdoms report local tax collection, the monies are not properly accounted for by the tax collectors, either to the chiefdoms or local councils in question. The local councils also have made little effort to ensure that they receive their actual and fair share of the tax collected. Over the years the practice has been that the district local councils always accepted, as their own share, without questions, any amount the chiefdoms reported as local tax collection. In the case of the city councils (with the exception of Freetown City and WARDC), the local tax precepts are nil despite the fact that chiefdoms are located within city council jurisdictions.

The cost of printing the local tax receipt books over the years was borne by the central government through the ministry responsible for local government and the World Bank. Ideally the chiefdoms are expected to bear the cost of collection, but it is clear that shared revenues reported as collection would not even pay three months salary of chiefdom functionaries after deducting rebates to section and village chiefs in instances where they fully participate in the collection.

2.2.2 Property Tax

The definition of property as articulated in Section 70 of the LGA of 2004 is all buildings (including buildings owned or occupied by the government and the local council). The current problem of many councils is that they have no database on which to levy property rates. In the city councils, some databases do exist but the lists of properties are incomplete and out-of-date, the ownership/occupancy of many properties is unknown, and the valuations are very old. This is coupled with the paucity of qualified staff in the valuation departments, where it exists (city councils); a lack of computer skills by the staff of these departments; a history of significant tax defaults; and the nonexistence of real estate markets, to the extent that the relevant provision in the Act on Property Valuation (Section 72.1) could not be easily adopted. The so-called tax appraisers have used these developments as an opportunity, over the years, to arbitrarily determine how much owners/occupiers should pay as rates.

2.2.3 Fees and Charges/Market Fees

Section 57 (a) of the LGA of 2004 states that local councils shall charge fees for the use of markets. The fee is payable by all stallholders and vendors in the vicinity of the market on a daily basis, including weekends. It is not limited to those operating from council property, unless it also included roads and footpaths.

In the 13 district council areas, many markets are currently owned or managed by the chiefdom councils. For this reason, and to enable them to cover maintenance costs and payments for the renting of land from the landowners, the ministry responsible for local government established a transitional arrangement, whereby the chiefdoms should pay the 13 district councils “up to 20 percent” of the total collection of market fees. However, in local council areas where chiefdoms do not exist (the five cities, Bonthe municipality, and WARDC), market dues are not shared and accounted for more than 50 percent of the revenues collected by these councils.

By the nature of its collection, it is evident that the collectors hardly account for the actual revenues collected per day, and the councils are not making any extra effort to ensure that revenues from markets are properly accounted for, even with the realization that collection costs are higher and despite knowing what options are available for reducing these costs. There are specific instances in some city councils where collectors have been subject to demands of the mayors in terms of what is expected to be accounted for as market fee collections per day.

2.2.4 Business Licenses

All businesses or business people are legally obliged to pay something loosely called the **right to trade tax** to their council. For very small businesses, it is called market fees and is paid daily. For all others, it is called a business license fee and is paid annually. The current arrangement is confusing and has resulted in huge inequities. It is unclear whether the tax is being levied on individuals or businesses (is it an accountant or an accounting business)? Like the case with property rates, the councils have no baseline information on the number of businesses that should attract licenses. In the city councils, some databases do exist but the lists of businesses are incomplete and out-of-date; the ownership/occupancy of many of the businesses is unknown.

2.2.5 Mining Royalties

Section 60 of the LGA 2004 states that the councils shall be entitled to a share of revenues from mining as may be determined by the ministry responsible for local government after consulting the ministries responsible for finance and mineral resources. The mining share comprises surface rents from small- and large-scale mining and the mining area community development fund.

Eighty percent of *surface rents* from small-scale mining are shared with the chiefdoms whilst surface rent from large-scale mining are shared among the chiefdoms, landowners, paramount chief, and the local council in the ratio 2:4:2:2, respectively. However, benefiting councils are those in which the mining has taken place. Here, a few councils will become very wealthy if diamond, rutile, or bauxite mining become large industries. For the revenue distributed through the Community Development Fund[7] (80 percent shared with chiefdoms), which is collected by the Ministry of Mineral Resources, the Statutory Instrument on Devolution lists this as a function to be devolved. If this is to happen, there may still be opportunities to change the operational aspects of this fund.

2.3 Reforms in Revenue Administration

In Sierra Leone, recent reforms have been undertaken in the administration of property tax and business licenses. Given the key constraints faced by the local councils, especially the city councils over the years in the administration of property rates and business licenses, a new program to raise local revenues was created with the support of Mr. Paul Fish, a Canadian Chartered Surveyor, assigned to Sierra Leone as Voluntary Service Overseas (VSO). The objective of the system is to introduce an assessment of all properties and businesses so that a fair system of taxation can be implemented. The success of the program depends on the cumulative performance of five critical steps: discovery, assessment, billing, sensitization in a form of public awareness campaign, and collection.

This method of determining the assessment of properties and businesses is based on value-derived points awarded to physical properties in order to indicate the annual ratable value. This simplifies the valuation and makes it adaptable to a formula and to automation. Since the professional valuation capabilities of staff have been limited so far, a simplified "points-based" system is preferred. The new system uses a basic or initial tariff for each type of use and is applied to the area of the building, measured in square feet, to arrive at an initial annual ratable value.

The basis of the tariff is the relative cost of construction. However, data on the cost of construction are not available locally in Sierra Leone with any consistency or accuracy. Thus, the system in the cities of Bo, Makeni, and Kenema relies on data about the relative cost of constructing buildings in North America, since such a database is reliable and is widely used. Sierra Leone taxpayers have expressed their concern about the nature of the cost data and the high cost of construction in North America. However, it is not the actual cost that is used but the relative cost. The intention is to assess a high-cost building such as a bank at a higher tax rate compared to a simple retail shop. The relative cost in North America will suffice in the absence of local information in Sierra Leone. Updating the relative cost is not required on a frequent basis since the relative costs are unlikely to change over time.

This system allows for the adjustment of the tariff to handle the grading of poorer or better property features. The success of the property assessment system hinges on fairness and progression. A progressive point-based system aims to tax a greater amount to those more able to bear the cost and vice versa. In local council areas where the system is currently operational (Bo, Makeni, and part of Kenema), a sharply progressive system was required since poverty is widespread, along with a small class of those who are better off.

3. THE APPROACH AND METHODOLOGY

3.1 Research Design and Focus

This study relies upon case studies that largely suited a qualitative research approach, but with some elements of quantitative data application. This choice was based on the nature of the research that intended to provide an in-depth and systematic analysis of how local taxes are administered by local councils in the Sierra Leone economy, much of which is informal. The research concerned six local government institutions in the cities of Freetown, Bo, Makeni, and Kenema, along with the Kenema District and the Dama Chiefdom, each operating in a case-specific environment (local government sphere). Fieldwork was conducted to investigate the operations of the local government agencies in question.

Given that the study was about local taxation in a highly-informal economy, the research utilized both qualitative and quantitative data to analyze the institutional operations of the six local government institutions in order to understand the notion of the administration of the various local taxes, in relation to the following aspects:

- How and by whom are these local taxes levied?
- What is the scope of and abuse of local taxes?
- What is the performance of the local tax administration in terms of efficiency and effectiveness?
- What are the indications of the impact of the tax on equity?

Quantitative data generated from secondary sources in the form of statistics enabled a comparative assessment on the quantifiable elements related to performance.

The rationale for selecting these councils is as follows:

- The four city councils constitute the largest in terms of local own revenue collection among all 19 local councils and have settlements that are highly populated, implying a substantial number of actors in the informal sector.
- Located within the Kenema District, Kenema District Council and Dama Chiefdom were selected to critically analyze the relationship between the two institutions in terms of revenues collected and shared (local tax, market fees, and mining royalties.
- The selected councils represent all regions within Sierra Leone (see Figure 4.2).

Figure 4.2
Map of Sierra Leone Indicating the Case Study Councils

Source: GIS Mapping Unit of the Ministry of Finance and Economic Development (MOFED).

3.2 Study Population

The study generally enlisted four different types of people. First was senior administrative staff including elected representatives (mayors/chairpersons) and staff of revenue departments of local councils. They are the people's representatives at the local level and are supposed to understand and deal with revenue policy implementation issues on a daily basis, and from whom accountability is sought, by virtue of the devolved functions and public resources they hold.

The second group was officials from the National Revenue Authority (NRA) and the Registrar General's Department (RGD)—the central government department responsible for registering all businesses in the country. As the national revenue collection agency, the NRA was chosen to represent the relationship between taxes administrated at the local and national levels.

The third group was the business community, which is part of the taxpayer population but with specific reference to the payment of licenses and fees for the businesses (small medium, and large) they operate in the respective jurisdictions. This category of taxpayers is very useful as they form the bulk of the informal sector actors.

The fourth group was the residents of the respective local council jurisdictions who are legally obliged to pay their local taxes in return for services provided by the local councils.

Focus group discussions were conducted with the last two groups to yield a free-flowing discussion around topics relevant to the study. The focus group discussions aimed to garner opinions and ideas from local residents, businesses, and stakeholder groups to ensure that any development-oriented issues are sustainable and represent a broader public interest.

The essence was to ascertain the extent of service delivery and what were their perceptions of unofficial levies and monies that are collected but unaccounted for by revenue collectors. Participants were asked to explore an issue, sometimes loosely, sometimes thoroughly, by responding to more focused questions.

Structured questionnaires were administered to the following four categories of people mentioned above. The issues addressed across all four categories of groups in broad thematic areas are summarized in Annex 1.

The respondents for all the questionnaires were selected purposefully, since there was the desire to include specific sections of the study population that have in-depth information and understanding of the themes of the study. In total, eight focus groups and 219 respondents were interviewed (Table 4.1).

Table 4.1
Type and Number of Respondents for In-depth Interviews

Interviews by group	Organization	No. of focus groups	No. of respondents
Focus group discussion			
Kenema district	Diamond dealers and miners, farmers, school teachers	2	34
Kenema city	Market women, motorbike riders, petty traders, ordinary residents including property owners	1	18
Bo city	Market women, bike messengers, petty traders, ordinary residents including property owners	1	20
Makeni city	Market women, bike messengers, petty traders, ordinary residents including property owners	1	19
Freetown city	Market women, bike messengers, petty traders, ordinary residents including property owners	3	45
Interviews with the business community			
Kenema district	Small, medium, and large businesses		3
Kenema city	2 small, medium, and large businesses each		6
Bo city	2 small, medium, and large businesses each		6
Makeni city	2 small, medium, and large businesses each		6
Freetown city	3 small, medium, and large businesses each		9

Table 4.1 (Continued)

Interviews by group	Organization	No. of focus groups	No. of respondents
Interviews with government officials/elected representatives			
City mayors and district chairpersons and/or deputies			5
Chief administrators and/or deputies	Local councils		5
Local government finance officers	Local councils		5
Councilors	Local councils		10
Revenue collectors and appraisers	Local councils		15
Paramount chiefs	Chiefdom council		1
Central chiefdom finance clerk, treasury clerk, and chiefdom police	Chiefdom council		3
Assistant commissioner, research	National Revenue Authority		1
Principal economist, research	National Revenue Authority		1
Principal collector	National Revenue Authority		1
Senior collectors and collectors	National Revenue Authority		5
Deputy registrar general	Registrar General's Department		1
Total Focus Groups/Respondents		8	219

3.3 Data Collection Methods

Data for this study was collected from both primary and secondary sources. The study utilized three methods, namely: interviews, documents/records review, and direct observation. The use of these different methods was intended to enable the triangulation of data and make an assessment of the balance of evidence given.

- Face-to-face interviews were conducted to elicit primary data from key personnel in the case study institutions. Interview guidelines were used for different respondents. These guides consisted of themes and open-ended questions to be covered. The interview method was chosen as it suited the nature of the research.
- A document review involved the collection, study, and analysis of existing written (published and unpublished) materials. Documents reviewed include official institutional publications (reports, statistics, and figures); legal and regulatory instruments; published articles on fiscal decentralization and the informal sector.

3.4 Data Analysis

The data obtained from secondary sources was evaluated and compared with the data gathered from primary sources in order to support the balance of evidence and interpretations made in the study. The analysis of secondary sources began before and during the interview process. The preliminary review and analysis of documents enabled the research to identify the key thematic issues, and later during the interviews it helped in redesigning the questions in order to capture the analytical constructs. The secondary sources provided some elements of quantitative data in the form of statistical tables and figures, which enriched the analysis and helped to describe, translate, and provide meaning to issues captured from the interviews. The information generated from the in-depth interviews was transcribed and summarized according to the themes and the four specific objectives of the study.

4. DATA PRESENTATION, ANALYSIS, AND FINDINGS

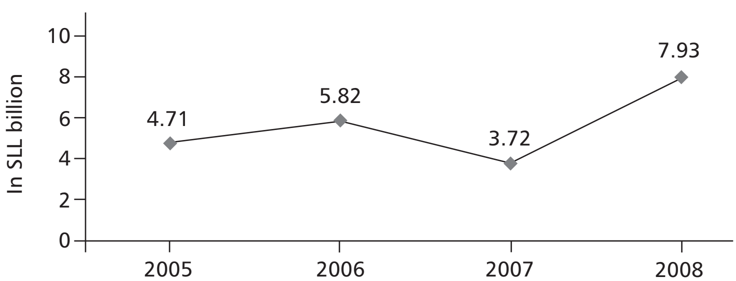
This section of the report presents the responses of elected representatives (mayors/chairpersons), the staff of revenue departments of local councils, officials from the NRA and RGDs, and the business community to the question of local tax collection.

4.1 Data Analysis from Secondary Sources

The total own revenues generated by all 19 local councils (tax and nontax revenues) reported an increasing trend for the period under review (2005–2008), except for fiscal year 2007 when own revenues dropped over half from their 2006 levels. One reason for this drop is was the negative signal sent by political parties regarding the non-payment of taxes during the national election period in August 2007. However, fiscal year 2008 marked a significant increase in own revenues from the previous years (Figure 4.3), partly due to an increased efforts by the city councils, and certainly the Freetown City Council (FCC), to collect these revenues. Most importantly, the radical approach used by FCC administration to change the locks on all businesses that fail to pay licenses and proper enforcement of the payment of rates largely account for this increase.

Furthermore, the development fund (formally the annuity fund) to the tune of SLL 7.55 billion transferred to the FCC from the Crown Agent Account in London[8] in fiscal year 2008, which represents over 45 percent of the total local own revenues reported by all local councils, also contributed to the significant increase in other revenues hence total revenues. This fund was partly used by FCC to pay staff bonuses and other fringe benefits accumulated over the years.

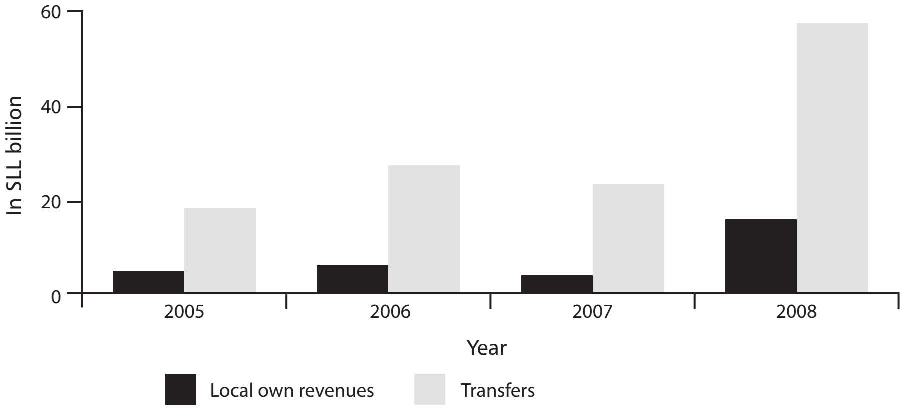
Figure 4.3
Local Own Revenues for Fiscal Years 2005–2008



Like the trends in local own sources observed during the period, central government transfers maintained a similar level and accounted for more than 70 percent of the total revenues available to the council to deliver services on average. Whilst transfers for fiscal year 2007 dropped significantly from its 2006 level because of uncertainties in the national election process, transfers for fiscal year 2008 more than doubled from 2006. This arose because fiscal year 2008 marked the end of the transition period wherein about 75 percent of the fiscal devolution to local councils was achieved (Figure 4.4).

Local own revenues accounted for on average less than two percent of central government domestic revenues, on average, and less than 0.5 percent of nominal GDP on average (Annex 1).

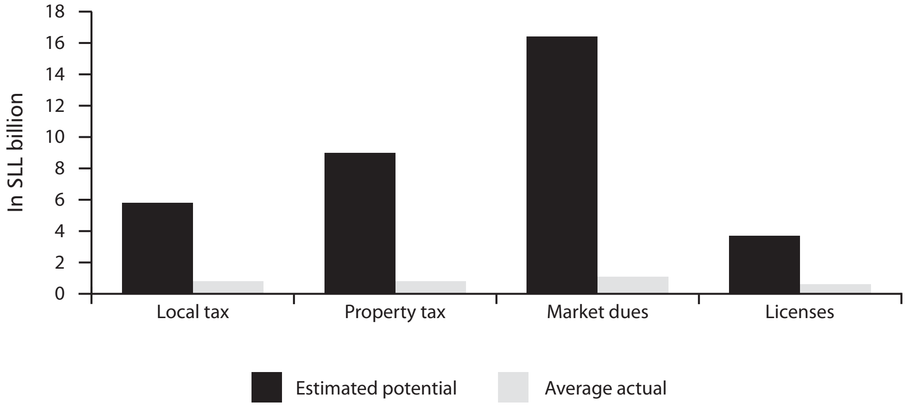
Figure 4.4
Local Own Revenues vs. Transfers for Fiscal Years 2005–2008



While local own revenues are increasing in nominal terms (averaging 25.5 percent annually), despite the shortfall realized in fiscal year 2007, inflation is averaging 12.4 percent. In real terms (constant 2004 prices), local own revenues continued to increase (9.5 percent) at a decreasing rate (25.5 percent) and at a rate less than inflation rate (12.4 percent). Similarly, central government transfers also increased (43.3 percent) but faster than both the inflation rate and local own revenues (Annex 1).

However, despite the increase in local revenues over the period, key revenue targets, though grossly underestimated, were not met. The local councils still collect an average of less than 16 percent of their revenue potentials. Annex 2 and Figure 4.5 show the actual revenues collected against the estimated full potential whilst Annex 3 gives an estimation of the full revenue potentials.

Figure 4.5
Average Actual Revenue vs. Estimated Potential for Fiscal Years 2005–2008



Local own revenues per capita, adjusted for a population growth of nearly 2.5 percent per year, showed an increasing trend in real terms, from SLL 906 to SLL 1,084, a 6.5 percent increase per year between 2005 and 2008. Total revenues per capita, including transfers, increased by 31.5 percent per year over this period (Annex 1).

Analysis of Revenues Collected from the Informal Sector

The next phase of the secondary data analysis focused on the components of local own revenues that are largely collected from informal sector, and its impact on the poor and middle income groups. These revenue sources are market fees, licenses, sales from local tax, property tax, and fees and charges. Trends in the performance of these revenue sources are depicted in Figure 4.6, which shows mix trends in market dues collected both in nominal and real terms. Licenses issued from businesses and local tax collected decreased sharply in 2006 and throughout 2007, except in 2008 when collections increased rapidly, back to their 2005 levels. These changes are attributed to the different signals sent by political parties before and during the election period in 2007 about the payment of local taxes. However, after the elections, changes in the political administration heads, coupled with enforcement mechanisms implemented by the city councils, improved the collection of the revenue sources in question.

Furthermore, other fees and charges (hire of city hall and recreation grounds, hire of other council property, rent of council property, jetty/landing fees, cemetery/burial fees, lorry park fees, slaughter house fees, market store rent, public toilets, parking fees, etc.) and property rates maintained an increasing trend over the period. Despite the average growth rate of property tax over the years exceeded 100 percent (Annex 2), performance was not encouraging compared to their estimated potential to raise local revenues (refer to Figure 4.5).

Figure 4.6
Trends in Revenue Sources Largely Collected from the Informal Sector, 2005–2008

4.2 Data Analysis from Primary Sources

Outlined below are the findings/observations of issues common across all sub-themes in the focus groups in the case studies of local and chiefdom councils and in the interviews with other stakeholders. Detailed responses from questionnaires administered in the focus group discussions are amplified in Annex 2.

4.2.1 Summary Feedback from Focus Group Discussions

Taxpayer Education and Knowledge of Taxpayers on Local Revenue Streams

- Focus groups in the city councils have some knowledge of the revenue administration provision by local councils in the LGA of 2004 and have some knowledge of the reasons for paying taxes (e.g., to undertake development programs and pay salaries). The opposite is true for residents in the district council jurisdictions.
- Receipts, whether valid or not, are issued for all taxes paid by residents.
- For daily market fee collection, sellers are indifferent about demanding receipts from fee collectors—and always deal with the same fee collectors.
- Fiscal year 2006 receipt books were issued for 2007 local tax collection.

Service Delivery

- Focus groups in the districts are less informed and have mixed feelings of the kind of services provided by either local councils and/or NGOs.
- Local councils do provide services that range from the construction of court barries, earth closet latrines, culverts, small bridges, public toilets, markets, schools, and solid waste management including cleaning the city, etc., as admitted by focus groups in the city councils.
- The willingness to pay local taxes should be matched with improved public services in the form of safe drinking water, electricity, good health facilities, etc.

Compliance

- The assessments of some of the tax systems are complex, subjective, and inequitable (property tax and business licenses). Average daily market fees at SLL 300 accumulated for the year (SLL 86,400) may exceed licenses paid annually for some businesses.
- There is excessive burden on taxpayers (NRA, local, and chiefdom councils) and double taxation resulted in resistance to pay or taxpayers overburdened with all kind of taxes.

Trust, Ethics, and Standards of Tax Collectors

- Tax collectors are dishonest in accounting for local revenues collected.
- Complaints to local/chiefdom councils about dishonest tax collectors are normally treated with levity.
- The commitment of tax collectors to work is associated with the expected personal gains.

4.2.2 Summary Feedback from Discussions with the Business Community

Socio-Economic Characteristics of Business/Taxpayers

- Owners/suppliers of businesses are either Sierra Leoneans or foreign-based nationals like Lebanese or Indians.
- Businesses are classified by both NRA and local councils into small, medium, and large-size but has no measurable guide to determine what constitutes a small, medium, and/or large business.

- Businesses pay licenses to both the NRA and local councils.
- Some businesses in Bo and Kenema cities admitted having knowledge of plans by these city council to design a system to equitably administer licenses and rates.

Taxpayer Education and Knowledge of Business Taxpayers

- License field officers receive both cash and checks and issue receipts on the spot for businesses. Small businesses in the district councils are indifferent about asking or receipts—and always deal with the same set of collectors.
- Licenses are either paid in cash at the revenue department section of the councils and/or the banks. The latter is applicable for Bo and Freetown city councils.
- The amounts businesses pay varies depending on the size, type of product, and category of the business. Large, medium, and/or small businesses pay licenses to both the NRA and local councils ranging from SLL 50,000 to SLL 500,000 per annum.
- Local councils hardly reach out in the chiefdoms to collect licenses and chiefdoms having been doing this for their own use.

Service Delivery

- Business taxpayers have not been informed of services provided by either local councils and/or the NRA.
- The quality of services provided by each council is questionable and has had no direct impact on business owners.
- There is excessive burden on business taxpayers. Both the NRA and local councils collect licenses. There is need to harmonize license rates so that one entity handles the collections.preferably the entity that will be easily held accountable —i.e., the local councils.

Compliance

- There is willingness to pay licenses and other fees and charges if the proceeds are development related and directly linked to service delivery.
- There is excessive burden on business taxpayers and small businesses admitted that they should not be taxed as most of what they earn is for the most basic survival.

Trust, Ethics, and Standards

- Revenue collectors are impartial but do not conform to the attributes of sincerity, professionalism, and honesty.

- Collectors often visit all categories of businesses and in the process have become permanent friends. Collectors do accept gifts from businesses.
- There are no instances where collectors use business information for personal or private gains, or disclose information about clients to third parties.

4.2.3 Summary Feedback from Discussions with Local and Chiefdom Council Officials

Personnel Size

Table 4.2 depicts the total average personnel of the local and chiefdom councils visited in the course of this study.

Table 4.2
Personnel of Local Councils

	Personnel	Market fee collectors	Other revenue departments (licenses, rates, etc.)	Average salary per annum for market fee collectors (SLL million)	Average salary per annum for staff of other revenue departments (SLL million)	Average salary per annum for all staff (SLL million)
Freetown city	367	130	75	1,164.69	55.99	3,288.00
Bo city	167	64	31	118.80	57.54	310.00
Kenema city	135	42	41	93.33	91.11	300.00
Makeni city	56	—	29	—	23.30	45.00
Kenema district	21	—	9	—	16.71	39.00
Dama chiefdom	22	1	5	1.20	7.72	31.90

General Administration of Local Own Revenues

- The most important and lucrative revenue sources for all the city councils are: market fees, property rates, licenses, and other fees and charges.
- Market fees, property rates, and licenses are solely collected and accounted for by revenue collectors of the city councils.
- Revenue collectors for the local district and chiefdom councils are mostly chiefdom functionaries, but many, especially treasury clerks, chiefdom police, etc., have gone without their salaries for over 24 months.

- The introduction of the decentralization policy in 2004 somehow resulted in the neglect of the chiefdom councils by the ministry responsible for local government especially in regards to the central government's payment of subventions and/or grants-in-aid.
- Assessment of these local own revenues was subjective, and the councils relied solely on collectors to collect and account for these revenues.
- No concrete enforcement mechanisms has been put in place by the councils to ensure payment of the key local revenue sources. However, the process of developing bylaws is in progress.
- The cities of Freetown and Bo have embarked on the closure of business entities that refuse to pay licenses. In addition, Bo is taking defaulters to court for the nonpayment of property tax.
- Bookkeeping is poor in the chiefdom in question and there are discrepancies between bank statements and bookkeeping records.
- Poor cash management was an outstanding feature in the chiefdom with the signatories to the account from the chiefdom having no idea of the amounts held with the banks.

Local Tax

- Much local tax revenue was neither collected nor accounted for by chiefdom functionaries (paramount chiefs, treasury clerks, and/or the central chiefdom finance clerks.
- Collected local taxes are either paid directly into the respective chiefdom's account or held by the treasury clerk and/or the paramount chiefs for safekeeping and later deposited into the bank.
- Local tax precepts for the councils are determined from the amounts deposited in the respectively bank accounts of the chiefdoms, of which the chief administrator of the district local council in question is a signatory.
- In 2008, a unilateral decision was taken by the minister responsible for local government to withhold precepts due to the city and district local councils. The withheld precept was claimed to be partly used to offset salary arrears of key chiefdom functionaries.

Market Fees

- The collection of market fees have been marked by an increase in the operating cost of doing so.
- In 2005, Makeni city contracted out the collection of market fees without doing a thorough assessment of the markets' potential. Over time, the contracted firm

was unable to meet its negotiated obligation to the council because of direct interference of some council personnel including councilors in the administration of the markets. The new council administration that took over in July 2008 reversed the decision and undertook an assessment of all markets in the city before awarding the contract. The result has been a somewhat increased collection of market fees reported by the contractor compared to previous arrangement.

Property Tax and Business Licenses

- The Institutional Reform and Capacity Building Project (IRCBP) and the UNDP support to the development of the property cadastre and business licensing registers in the cities of Makeni, Kenema, and Bo has resulted in the councils having updated information on properties and businesses. The councils have reported improved collection of rates and licenses.
- IRCBP support was further extended to the capital Freetown. Over 80,000 new properties and 7,000 new businesses have been discovered and documented. Fiscal year 2010 will see Freetown city reporting improved collection of rates and licenses.
- Similar support will be extended to other city and district local councils in the medium term.

Mining Revenues

- Assessment of mining revenues varies depending on the type of mining.
- Small-scale mining is assessed based on the number of licenses officially issued.
- The assessment of large-scale mining (diamond, rutile, etc.) is unpredictable in a sense that the amounts mining companies pay to chiefdoms, landowners, and local councils are not fixed and vary significantly.
- There are no records of chiefdoms' share of mining revenues, including landowners.
- A large share of the proceeds from the mining area community development fund, after being assessed by the ministry responsible for local government, goes directly into the chiefdom council's development account, of which the principal signatory is the paramount chief.

Service Delivery

- Services provided using local own revenues are meager.
- About 75 percent of what is reported as local own revenues, plus the administrative grants received from central government, is spent on the day-to-day running of the council administration.

- The key services provided by the councils are mainly from grants tied to the implementation of specific devolved services (education, primary and secondary healthcare, agriculture, solid waste management, etc.), plus projects using the Local Government Development Grant (LGDG). Projects implemented using the LGDG include, among others, road rehabilitation, construction of small culverts and bridges, and the construction and furnishing of schools.
- Citizens' perception about the outcomes of service delivery programs is mixed, but opines that service provision across all sectors should be significantly improved, especially the provision of services that are visible and whose impact is immediately felt.

4.2.4 Feedback from Discussions with NRA Staff and Officials of RGD

NRA

- Central government revenue sources are: customs and excise duties, income tax, road user charges, and nontax revenues, which include royalties from mines and marine resources, etc.
- The NRA Act states all monies collected by collectors should be deposited in the government's Consolidated Fund.
- Nontax revenue sources in the districts are collected by NRA collectors.
- NRA lacks the staff and logistics to reach other areas in the districts to collect revenues.
- Collectors in the districts are faced with numerous problems, ranging from collusion with local council collectors in collecting most nontax revenue sources, to resistance from taxpayers to paying these taxes (especially where there is perceived to be double taxation).
- Complaints with regards duplication in collection have mounted and have become a concern to NRA head office.

RGD

- The Registrar General's office principally located in Freetown is solely responsible for the registration of businesses that intend to operate within the country and the issuing of business licenses.
- The presence of the RGD in the local councils is limited.

- Businesses operating in the local council jurisdictions are supposed to first register with the RGD and then later pay licenses to either the NRA or the local councils (or both).
- In some local council areas it appears that certain businesses register with the local councils and pay licenses to both the NRA and local councils when approached.
- RGD staff have very little knowledge of the kinds of revenues administered and services provided by local councils.
- The level of collaboration between the RGD staff and the local councils, especially the Freetown City Council where the office is principally located, is minimal. The department is more associated with the NRA than FCC.

5. POLICY OPTIONS, EVALUATION CRITERIA, CONCLUSIONS, AND RECOMMENDATIONS

This part consider all possible options that are available to address local taxation issues of the informal economy—that is, what is currently been done, what others have suggested, and some objective suggestions in addressing the problems. Each option among all possible options selected to address the problem is evaluated and the preferred option was chosen that led to a reasonable conclusion on the impact of local taxation on informal economies with general and specific recommendations on the way forward.

5.1 Policy Options and Evaluation Criteria

Through brainstorming and consultations with key stakeholders in local and central government, the recommended option is to harmonize and rationalize the legal provisions and improve the administration of the already existing local own revenue sources.

Five evaluation criteria were adopted to compare the baseline scenario (where there is no change in policy) against the chosen policy option. These are:

- efficiency,
- effectiveness,
- equity,
- administrative ease, and
- legal issues.

Table 4.3
Outcome Matrix Explaining the Policy Options

Evaluation criteria	The current scenario No change in the current policy[9]	Harmonize and rationalize the legal provisions and improve the administration of the already existing local own revenue sources[10]
Efficiency		
1. Ratio of average costs of collection to local own revenues generated		
a. Local tax		
Ratio of average cost of collection to average local tax generated	48.6%	Strengthen supervision over chiefdoms to determine, collect, and account for the full potential of this revenue source.
b. Property tax		
Ratio of average cost of collection to average property tax generated	32.8%	Invest in determining the base, including realistic estimates of the potential. More specifically, adapt the existing property tax and business licenses reform to other local councils. Also provide incentives for collectors, but any increase in cost of collection should be less than proportionate to the increase in rates collected.
c. Market fees		
Ratio of average cost of collection to average market dues generated	82.6%	Contract out collection of market fees after a comprehensive assessment of all markets in the localities.
d. Licenses		
Ratio of average cost of collection to average licenses generated	21.2%	Invest in determining the base, including realistic estimates of the potential. More specifically adapt the existing reform to other local councils. Also provide incentives for collectors but any increase in cost of collection should be less than proportionate to increase in licenses collected.

Table 4.3 (Continued)

Evaluation criteria	The current scenario No change in the current policy[9]	Harmonize and rationalize the legal provisions and improve the administration of the already existing local own revenue sources[10]
2. Average revenue per capita (ratio of local own revenues to total population)	SLL 908.88	Ensure that local own revenues generated increase proportionately more than increase in population. E.g. if population increase by X%, local revenue generated should increase by more than X%.
3. Growth rate in revenues from the previous year to the current year (in real terms)	Local tax—6.4% Property rates—149.4% Market fees—26.7% Business licenses—3.6%	Maintain a steady increase in the growth rate in revenues from the previous year to the current year. The increase should be able to offset any increase in consumer prices.
Effectiveness		
1. Ratio of actual local own revenues reported to the average yearly budget estimates	Local tax—31.1% Property rates—34.4% Market fees—72.3% Business licenses—55.5%	Increase the ratio of all local own revenues reported to the budget estimates to at least 85–90% and budgets should be estimated based on reliable and readily available data.
2. Ratio of actual local own revenues reported to the estimated full potential revenues	Local tax—15.7% Property rates—10.5% Market fees—6.5% Business licenses—15.3%	Invest in determining the base, including realistic estimates of the potential. Increase logistics and incentives to tax officials to collect at least 85% of the estimated full potential.
3. Likely extent of tax evasion and fraud by tax officials	Substantial but magnitude unknown.	Improve on sensitization of residents on need to pay taxes and services to be provided in return. Also strengthen enforcement mechanisms on tax collection. Also increase remuneration to tax officials and incentives for improved collection.

4. The extent of tax collusion between the taxpayer and the official	▪ Poor conditions of service of tax officials (chiefdom functionaries have gone without salaries for over 24 months). Also, salaries of local councils staff are very low. ▪ Improper/subjective assessment of the amount of licenses and rates paid on businesses and properties, respectively.	Form a chiefdom governance policy with specific reference to chiefdom financial review to understand the nature of chiefdom finance—what is being financed and how, and what should be financed in the future and how?
5. *Ratio of actual to budgeted transfers*	55–65%	
Equity and Neutrality		
1. Neutrality – no discrimination based on how the tax system is conducted	Different rates for different properties and or businesses. The decision is subjective and based on discretion of tax officials.	
2. The extent of double taxation of the informal actors	Conflicting provisions in the LGA of 2004 and the guidelines issued by the ministry responsible for local government on revenue collection and sharing.	Harmonize and repeal the relevant provisions in other legislations (income tax, tourism, factory and forestry acts, etc.), to be consistent with provisions in the LGA of 2004.
3. Percentage of tax that is used for service provision	Between 15–20%	Ensure that councils budget use at least 60–70% of local own revenues for direct service delivery before budget is approved.
4. Institutional and technical capacity	Low institutional and technical capacity to deliver on the current and expected services.	Provide both demand- and supply-driven capacity building programs for all local stakeholders including the devolved staff as an ongoing process.

Because of the continued commitment from donors (World Bank, EU, and DfID) to support the ongoing decentralization process, a premium was not put on the associated cost as an evaluation criterion. Also, because of the government's commitment to fast track the smooth implementation of the decentralizing process as articulated in the country's second Poverty Reduction Strategy (PRS II)—The Agenda for Change, in addition to the benchmarks set by the said donors for the government to protect the decentralization agenda, the political acceptability as evaluation criteria is also not considered. Analysis of the current and chosen policy options is shown in Table 4.3. The analysis is limited to the key revenue sources that are largely collected from informal sector that impact on the poor and middle-income groups (local tax, property rates, market fees, and licenses).

5.2 Conclusion

The primary objective of this study on local taxation of informal economies in Sierra Leone sought to examine how local taxes are administered, in terms of efficiency, effectiveness, and equity, by local councils in the local economy, much of which is informal.

Local taxation has failed to generate sufficient revenues for the improvement and expansion of public services in Sierra Leone. Relatively straightforward legislative and administrative changes to address insufficient revenue collection would help increase revenues while also bringing public services to local communities that are in desperate need of better schools and healthcare. International donors have been supportive of this through a general trend towards decentralization in Sierra Leone, while the government has struggled to implement these changes through parallel layers of local councils and chiefdoms that also hold an important function in Sierra Leonean society.

5.3 Recommendations

Improving the administration of local own revenues and improving public service delivery would imply the following tasks if improvements are to be made, allowing for a widespread improvement in the lives of citizens involved in both the formal and informal economy of Sierra Leone:

1. Invest in determining the revenue bases of the local taxes including realistic estimates of the revenue potentials. More specifically adapt the existing property tax and business licenses reform and should be rollout to other local councils. The reform has worked (see Annex 4—a case study of Bo City Council).

2. The city councils should contract out the collection of some of the local revenue sources like market fees. The burden of increased collection cost will shift to the contractor and eventually reduce the pressure on the respective council's payroll.
3. Embark on a massive public campaign to inform residents of the need to pay taxes and the public services to be provided in return.
4. Strengthen enforcement mechanisms on tax collection through establishing local bylaws.
5. Form a chiefdom governance policy with specific reference to chiefdom financial review to understand the nature of chiefdom finance—what is being financed and how, and what should be financed in the future and how.
6. Review and repeal the provisions in other legislation to be consistent with provisions in the LGA of 2004. By educating and sensitizing the public as to the changes and expectations in Sierra Leonean tax law, residents will know who should collect what and which services should be provided by whom.
7. Ensure that councils budget use at least 60–70 percent of local own revenues for direct service delivery before approval.
8. Provide both demand- and supply-driven capacity building programs for all local stakeholders, including the devolved staff as an ongoing process.

Specific Recommendations Include:

1. The assessment of shared revenue should be jointly done by the local and chiefdom councils using section/village chiefs based on the available data on eligible local taxpayers and the number of markets.
2. After assessment, the local councils should announce the number of eligible local taxpayers for every chiefdom and the amount each chiefdom/local council shall receive if the eligible taxpayers pay.
3. The cost of printing shared revenue receipt books should be jointly determined and financed.
4. The requisition for the printing of local tax receipts should be sent to the government printer at least three months before the end of every financial year so that distribution of local tax receipts starts in January each year.
5. Whilst the chiefdoms are collecting the revenues using either treasury clerks and or section/town chiefs, the local councils should provide an adequate supervisory role.

6. Local tax precepts payments by the chiefdoms should be done on a quarterly basis so service provision is not derailed by the local councils.
7. There will, however, be a further increase in the cost of administering the tax by both the local and chiefdom councils. One should ensure that any increase in cost should be less than proportionate to the proceeds of the tax collection at the maximum compliance rate, hence the overall increase in the ratio of local tax collection to the costs of collection.

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ANNEX 1

Table 4.4
Actual Revenues of all 19 Local Councils in Sierra Leone 2005–2008

	In SLL billion, unless otherwise indicated				
Revenue source	**2005**	**2006**	**2007**	**2008**	**Growth rate average percent per year (2005–2008)**
Tax Revenues	1.49	1.17	1.19	3.02	
Local Tax	1.20	0.31	0.30	1.43	6.4%
Property Rates	0.29	0.86	0.89	1.59	149.4%
Nontax Revenues	**3.22**	**4.65**	**2.53**	**5.29**	
Fees and Charges	1.09	2.22	1.49	2.66	48.0%
Market Dues	0.96	2.01	1.14	1.73	26.7%
Other Fees and Charges	0.13	0.21	0.35	0.93	205.1%
Business Registration	0.03	0.02	0.02	0.04	11.1%
Licenses	1.48	0.34	0.20	1.64	3.6%
Mining Royalties	0.57	1.85	0.52	0.56	–0.6%
Others local revenues[11]	0.05	0.22	0.30	0.39	226.7%
Total Local Own Revenues	**4.71**	**5.82**	**3.72**	**8.31**	**25.5%**
Total Central Government Transfers	**17.99**	**26.95**	**19.30**	**56.82**	**71.9%**
Total central government budgeted transfers	**26.50**	**44.70**	**54.20**	**67.80**	**51.9%**
Total Revenues	**22.70**	**32.77**	**23.02**	**65.13**	**62.3%**
Administrative expenses (personnel (excluding councillors sitting fees and allowances) and non-personnel)	**3.89**	**5.13**	**3.22**	**13.07**	
Local own revenues as share of total revenue	20.7%	17.8%	16.2%	12.8%	
Actual transfers to budgeted transfers	**67.9%**	**60.3%**	**35.6%**	**83.8%**	
Price Index (2000 = 100)	138.67	140.12	166.84	190.42	12.4%
Local own revenues at 2004 prices	4.6	5.6	3.0	5.9	9.5%
Total transfers	17.6	26.1	15.7	40.6	43.3%
Total revenues at 2004 prices	22.3	31.8	18.8	46.5	36.3%

Revenue Source	2005	2006	2007	2008	Growth rate average percent per year (2005–2008)
Population (thousands)	5,095	5,217	5,343	5,474	2.5%
Local own revenue per capita at constant 2004 prices (Leones)	906.26	1,082.25	567.23	1,083.77	6.5%
Total revenues per capita at constant 2004 prices (Leones)	4,367.74	6,093.68	3,510.10	8,494.08	31.5%
Central government domestic revenues	416.00	495.60	536.90	692.70	
Total central government revenues	727.90	1,351.20	2,129.30	1,060.90	
Nominal GDP	2,894.30	4,213.70	4,969.80	5,873.40	
Total transfers as share of central government domestic revenues	4.3%	5.4%	3.6%	8.2%	
Total transfers as share of central government revenues	2.5%	2.0%	0.9%	5.4%	
Administrative expenses as share of local own revenues	82.6%	88.1%	86.6%	157.3%	
Local own revenues as share of central government domestic revenues	1.13%	1.17%	0.69%	1.20%	
Local own revenues as % of GDP	0.16%	0.14%	0.07%	0.14%	
Total revenues as share of central government domestic revenues	5.46%	6.61%	4.29%	9.40%	
Total revenues as % of GDP	0.78%	0.78%	0.46%	1.11%	

Notes: Annual average growth rates calculated as the difference between year 1 and year 4 divided by 3; strictly speaking, this is an approximation, and can be misleading if the first or last years are abnormal; (the true average annual rate should be calculated using least-squares method).

ANNEX 2

Table 4.5

Analysis of Average Actual, Budgeted and Full Potentials of Local Revenues, FYs 2005–2008, and Estimation of Efficiency Indicators

	In SLL billion, unless otherwise indicated														
	2005		2006		2007		2008		Avarage						
Revenue Source	**Bud.**	**Act.**	**Bud.**	**Act.**	**Bud.**	**Act.**	**Bud.**	**Act.**	**Bud.**	**Act.**	**Average estimate of shared revenue**	**Actual as percent of budgeted**	**Potential**	**Budgeted as percent of potential**	**Actual as percent of estimated full potential**
Tax Revenues	4.74	1.49	5.92	1.17	4.92	1.19	5.38	3.02	5.24	1.72	2.93				
Local Tax	2.35	1.20	2.63	0.31	2.62	0.30	2.82	1.43	2.61	0.81	2.03	31.1%	5.17	50.4%	15.7%
Property Rates	2.39	0.29	3.29	0.86	2.30	0.89	2.56	1.59	2.64	0.91		34.4%	8.67	30.4%	10.5%
Nontax Revenues	**5.00**	**3.22**	**5.68**	**4.65**	5.93	2.53	6.62	5.29	5.81	3.92	4.01				
Fees and Charges	2.25	1.09	2.64	2.22	3.06	1.49	3.08	2.66	2.76	1.87	1.95	67.6%			
Market Dues	1.74	0.96	2.04	2.01	2.09	1.14	2.21	1.73	2.02	1.46	1.55	72.3%	21.16	9.5%	6.9%
Other Fees and Charges	0.51	0.13	0.60	0.21	0.97	0.35	0.87	0.93	0.74	0.41		54.9%			
Business Registration	0.08	0.03	0.03	0.02	0.12	0.02	0.09	0.04	0.08	0.03		34.4%			
Licenses	1.33	1.48	1.56	0.34	1.76	0.20	1.95	1.64	1.65	0.92		55.5%	6.00	27.5%	15.3%
Mining Royalties	1.15	0.57	1.27	1.85	0.91	0.52	1.02	0.56	1.09	0.88		80.5%			
Others local revenues	0.19	0.05	0.18	0.22	0.08	0.30	0.48	0.39	0.23	0.24		103.2%			
Total Local Own Revenues	**9.74**	**4.71**	**11.60**	**5.82**	**10.85**	**3.72**	**12.00**	**8.31**	**11.05**	**5.64**	**6.94**	51.1%			
Total Central Government Transfers	**26.5**	**17.99**	**44.70**	**26.95**	**54.20**	**19.30**	**67.80**	**56.80**							
Total Revenues	**36.24**	**22.70**	**56.30**	**32.77**	**65.05**	**23.02**	**79.80**	**65.11**	**11.05**	5.64		49.6%			12.1%

Table 4.6
Estimation of Efficiency Indicators

			in SLL million, unless otherwise indicated			
Ratio of estimated cost of local tax collection to the average local tax generated						
Average cost of collecting local tax[1]	**Treasury clerks**	**CCFCs**	**Rebates**	**Estimated cost of collection for FCC**	**Estimated cost of collection for WARDC**	**Estimated amount (SLL million)**
Estimated cost of collection by chiefdoms and city councils	268.2	28.8	101.25	96.9	20.6	515.7
	No. of chiefdoms	**Estimated total for all district councils**	**Cost per receipt book of 50 (SLL)**	**Estimated cost of collection (SLL)**	**Estimated cost of collection (SLL million)**	
Cost of printing local tax receipt books	149	46,885	10,000	468,850,000	468.85	
Average cost of collecting local tax[1] (SLL million)						984.6
Average cost of collecting local tax[1] (SLL billion)						0.985
Average cost of collection to average local tax generated						48.6%

Table 4.7

Ratio of Estimated Cost of Property Tax Collection to the Average Property Tax Generated

	Estimated cost for FCC		Estimated cost for Bo city		Estimated cost for Kenema city		Estimated cost for Makeni city		Estimated cost for WARDC & Koidu city		Estimated cost for district local councils	
Average cost of collecting property tax	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**
	23	4,560,000	10	2,160,000	8	2,400,000	6	1,800,000	8	1,800,000	5	1,800,000
Estimated cost of collecting property rates (SLL)—FCC		105,264,000										
In SLL million		105.26										
Estimated cost of collecting property rates (SLL)—Bo city				21,600,000								
In SLL million				21.6								
Estimated cost of collecting property rates (SLL)—Kenema city						19,200,000						
In SLL million						19.2						
Estimated cost of collecting property rates (SLL)—Makeni city								10,800,000				

	Estimated cost for FCC		Estimated cost for Bo city		Estimated cost for Ken-ema city		Estimated cost for Makeni city		Estimated cost for WARDC & Koidu city		Estimated cost for district local councils	
Average cost of collecting property tax	No. of staff	Average wage per staff per annum	No. of staff	Average wage per staff per annum	No. of staff	Average wage per staff per annum	No. of staff	Average wage per staff per annum	No. of staff	Average wage per staff per annum	No. of staff	Average wage per staff per annum
In SLL million								10.8				
Estimated cost of collecting property rates (SLL)—WARDC										14,400,000		
In SLL million										14.4		
Estimated cost of collecting property rates (SLL)—Other LCs												9,000,000
In SLL million												9.0
Estimated cost of property tax collection for all LCs (SLL million)												180.3
Estimated cost of property tax collection for all LCs (SLL billion)												0.180

Table 4.7 (Continued)

	Estimated cost for FCC		Estimated cost for Bo city		Estimated cost for Ken-ema city		Estimated cost for Makeni city		Estimated cost for WARDC & Koidu city		Estimated cost for district local councils	
Average cost of collecting property tax	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**
Estimated cost of printing and distributing demand notices (SLL million)		70.0		8.0		5.0		4.0		25.0	5.0	117
Estimated cost of printing and distributing demand notices (SLL billion)		0.07		0.01		0.01		0		0.03	0.01	0.12
Average cost of collection to average property tax generated												32.8%

Table 4.8

Ratio of Estimated Cost of Collecting Market Dues to the Average Market Dues Generated

	Estimated cost for FCC		Estimated cost for Bo city		Estimated cost for Kenema city		Estimated cost for Makeni city		Estimated cost for WARDC & Koidu city		Estimated cost for district local councils	
Average cost of collecting market dues	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**
	130	4,200,000	64	3,000,000	42	3,000,000	0	0	40	3,360,000	133	1,200,000
Estimated cost of collecting property rates (SLL)—-FCC		546,000,000										
In SLL million		546.0										
Estimated cost of collecting property rates (SLL)—Bo city				192,000,000								
In SLL million				192.0								
Estimated cost of collecting property rates (SLL)—Kenema city						126,000,000						
In SLL million						126.0						
Estimated cost of collecting property rates (SLL)—Makeni city								0				
In million Leones								0				
Estimated cost of collecting property rates (SLL)—WARDC										134,400,000		
In SLL million										134.4		

Table 4.8 (continued)

Ratio of Estimated Cost of Collecting Market Dues to the Average Market Dues Generated

	Estimated cost for FCC		Estimated cost for Bo city		Estimated cost for Kenema city		Estimated cost for Makeni city		Estimated cost for WARDC & Koidu city		Estimated cost for district local councils	
Average cost of collecting market dues	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**
Estimated cost of collecting property rates (SLL)— Other LCs												159,600,000
In SLL million												159.6
Estimalted cost of collecting market dues for all LCs (SLL million)												1,158
Estimalted cost of collecting market dues for all LCs (SLL billion)												1.160
Estimated cost of printing market dues receipts (SLL million)		60.0		10.0		8.0				10.0	30.0	118.000
Estimated cost of printing market dues receipts (SLL biilion)		0.06		0.01		0.01				0.01	0.03	0.12
Average cost of collection to average market dues generated												82.6%

Table 4.9

Ratio of Estimated Cost of Collecting Licenses to the Average Business Licenses Generated

	Estimated cost for FCC		Estimated cost for Bo city		Estimated cost for Kenema city		Estimated cost for Makeni city		Estimated cost for WARDC & Koidu city		Estimated cost for district local councils	
Average cost of collecting business licenses	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**
	15	4,560,000	5	2,880,000	8	3,240,000	4	2,400,000	8	3,600,000	26	1,800,000
Estimated cost of collecting property rates (SLL)—FCC		68,400,000										
In SLL million		68.4										
Estimated cost of collecting property rates (SLL)—Bo city				14,400,000								
In SLL million				14.4								
Estimated cost of collecting property rates (SLL)—Kenema city						25,920,000						
In SLL million						25.92						
Estimated cost of collecting property rates (SLL)—Makeni city								9,600,000				
In SLL million								9.6				
Estimated cost of collecting property rates (SLL)—WARDC										28,800,000		

Table 4.9 (continued)

Ratio of Estimated Cost of Collecting Licenses to the Average Business Licenses Generated

	Estimated cost for FCC		Estimated cost for Bo city		Estimated cost for Kenema city		Estimated cost for Makeni city		Estimated cost for WARDC & Koidu city		Estimated cost for district local councils	
Average cost of collecting business licenses	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**	**No. of staff**	**Average wage per staff per annum**
In SLL million										28.8		
Estimated cost of collecting property rates (SLL)—Other LCs												46,800,000
In SLL million												46.8
Estimated cost of collecting market dues for all LCs (SLL million)												193.9
Estimated cost of collecting market dues for all LCs (SLL billion)												0.194
Average cost of collection to average business licenses generated												21.2%
Average cost of collecting the key revenue sources to the average total own revenues generated												36.3%

ANNEX 3

Table 4.10

Estimation of the Potentials of Key Revenue Sources

	Eligible taxpayer population		Local tax rate	Total amount to be paid		40% precept to other local councils	40% precept@90% compliance rate	FCC&WARD C collection of local tax@90% compliance	Total collection@full potential
	FCC&WARD C	Other local councils		FCC&WARD C	Other local councils				
Local Tax	469,831	1,866,897	5,000	2,349,155,000	9,334,485,000	3,733,794,000	3,360,414,600	2,114,239,500	5,474,654,100

	Estimated no. of properties		Average property tax rates		Total property rates@90% compliance		Average total rates collection@full potential
	City councils (including WARD C)	District councils	City councils	District councils	City councils	District councils	
Property Rates	174,200	104,300	50,000	10,000	7,839,000,000	938,700,000	8,777,700,000

	Estimated no. of busiesses		Average business licenses		Total licesnses@90% compliance		Average total licenses collection@full potential
	City councils (including WARD C)	District councils	City councils	District councils	City councils	District councils	
Business Licenses	27,566	14,900	120,000	40,000	2,977,128,000	536,400,000	3,513,528,000

Table 4.11
Market Dues

Council	Projected 2008 population	Projected 2008 tax-payer population	Informal sector comprise of on average 1/5 of the tax-payer population of the city councils and 1/10 of the taxpayer population of the district councils	Total collection@SLL 72,000 per annum (average SLL 250 collection per day)	20% share to district councils	Total collection @80% compliance
Kailahun D	401,389	267,726	26,773	1,927,630,534	385,526,107	308,420,885
Kenema D	377,067	251,504	25,150	1,810,826,561	362,165,312	289,732,250
Kenema C	187,869	125,309	25,062	1,804,444,171		1,443,555,337
Kono D	202,494	135,063	13,506	972,457,186	194,491,437	155,593,150
Koidu C	69,239	46,182	13,848	997,041,600		797,633,280
Bombali D	313,480	209,091	20,909	1,505,456,352	301,091,270	240,873,016
Makeni C	110,145	73,467	14,693	1,057,920,696		846,336,557
Kambia D	294,049	196,131	19,613	1,412,140,918	282,428,184	225,942,547
Koinadugu D	288,672	192,544	19,254	1,386,318,413	277,263,683	221,810,946
Port Loko D	478,782	319,348	31,935	2,299,302,677	459,860,535	367,888,428
Tonkolili D	373,953	249,427	24,943	1,795,871,887	359,174,377	287,339,502
Bo D	347,610	231,856	23,186	1,669,362,264	333,872,453	267,097,962
Bo C	222,561	148,448	29,690	2,137,653,893		1,710,123,114
Bonthe D	134,192	89,506	8,951	644,443,661	128,888,732	103,110,986
Bonthe C	10,309	6,876	344	24,753,971		19,803,177
Moyamba D	234,963	156,720	15,672	1,128,386,311	225,677,262	180,541,810
Pujehun D	293,509	195,771	19,577	1,409,547,622	281,909,524	225,527,619
WARDC	231,294	154,273	30,855	2,221,532,611		1,777,226,089
Freetown C	901,953	601,603	120,321	8,663,078,174		6,930,462,540
		3,650,845				**16,399,019,195**

ANNEX 4

Case Study of the Revenue Reform in Bo City Council

Property tax and business licenses reform has worked in the city of Bo

Objective of Reform
Introduce an assessment of all properties and businesses so that a fair system of taxation can be implemented.

The success of the property assessment system depends on the cumulative performance of five critical steps: discovery, assessment, billing, sensitization, and collection; and hinges on fairness and progression.

Bo

In November 2008, the following results were achieved.

- Demand notices printed and distributed in January 2009.
- The total amount billed for property taxes was SLL 630 million against an estimate of SLL 180 million for the year.
- As at end June 2009, SLL 350 million was collected compared to SLL 84.9 million reported for the whole of fiscal year 2008.

Freetown

The data collection of properties and businesses has recorded over 100,000 properties and 30,000 businesses compared to less than 44,000 properties and 5,000 businesses reported in fiscal year 2008. The billing system for properties and businesses will be done by end of fiscal year 2009. Demand notices will be printed and issued during the first quarter of fiscal year 2010.

ANNEX 5

Explanatory Notes on Key Assumptions for the Estimation of the Full Potentials of Key Revenue Sources and the 3 Es (Efficiency, Effectiveness, and Equity)

Local Tax

- Estimated taxpayer population was based on 2004 statistic figures on ages 21 and above for all local council areas.
- FCC and WARDC were treated separately from the rest of the local councils because local tax is not shared in these two councils.
- The full potential of this revenue source was based on a 90 percent compliance rate.
- Cost of collecting local tax = salaries of stakeholders involved in assessment and collection at chiefdom level (treasury clerks, central chiefdom finance clerks, and chiefdom police) + rebates to section and town chiefs) + cost of printing local tax receipt books.
- On average, 4–5 percent of the proceeds of local tax collected go as rebates to section and or village/town chiefs.
- Average salary of treasury clerk per annum is SLL 1.8 million and that of the central chiefdom finance clerks is SLL 2.4 million.
- The collection of local tax in Freetown City Coucil is contracted to internship students, ward committee members, etc., for a fee of five percent per receipt administered.
- The collection of local tax in WARDC is contracted to tribal heads for a fee of five percent per receipt administered.
- Bo city, Kenema city, and Makeni city councils are not involved in local tax collection because chiefdoms are located within the respective jurisdictions.
- The full potential of this revenue source was estimated at a 90-percent compliance rate.

Property Tax

- Estimated number of properties for Makeni, Bo, and Kenema cities is known. However, estimated number of properties for Freetown and WARD C was based on the average number of housing units estimated by the Statistics Office of Sierra Leone.
- For the district councils the focus was on structures situated in the chiefdom headquarter towns that are assessable (estimated), multiplied by the number of chiefdoms.
- Cost of collecting property tax = salaries of bailiffs and valuation staff of the city councils including WARD C + salaries of estimated number of valuation staff in the district councils, where applicable + cost of printing and distributing demand notices where applicable.
- The full potential of this revenue source was estimated at a 90-percent compliance rate.

Market Fees

- It is assumed that dues are collected from traders in the markets from and street vendors.
- Two-thirds of the projected 2008 population is assumed to be the taxpayer population.
- Given the complex structure in administering this revenue source, it is assumed that the informal sector comprise of on average one-fifth of the taxpayer population of the city councils and one-tenth of the taxpayer population of the district councils.
- Cost of collecting market dues = salaries of market fee collectors of the city councils including WARD C but excluding Makeni city + salaries of estimated number dues collectors in the district councils + cost of printing market fee receipt books, where applicable.
- The full potential of this revenue source was estimated at a 90-percent compliance rate.

Business Licenses

- The estimated number of businesses for the cities of Makeni, Bo, and Kenema are known. However, the estimated number of businesses for Freetown and

WARD C was based on an adjustment factor by the number of businesses in Bo, for instance (second city). Example, the size of businesses in Freetown is X times the number of businesses in Bo city.

- Cost of collecting business licenses = salaries of license collectors of the city councils including WARD C + salaries of estimated number of staff collecting licenses for the district councils.
- The full potential of this revenue source was estimated at 90 percent compliance rate.

NOTES

1 LGFC is a statutory committee responsible to recommend to the minister responsible for finance the amount of grant allocations to each local council and indicate the formulae used in arriving at the various amounts recommended.

2 2004 Statistics Sierra Leone Population Estimated Data.

3 Sierra Leone Interim Poverty Reduction Strategy (SL–IPRS) Paper.

4 The finances, assets, and personnel should accompany all functions outlined in the Statutory Instrument that should transferred to the local councils.

5 C. Magbaily Fyle (1988) *History and Socioeconomic Development in Sierra Leone.* A SLADEA Publication. pp 149–179.

6 Ward committee is established by the LGA 2004 and comprise of the councilor of the Ward, the Paramount Chief in the locality where the Ward is located and 10 other members, at least five of which should be women resident in the Ward. The primary responsibilities of this committee are to mobilize residents of the ward for the implementation of self-help and development projects and provide a focal point for the discussion of local problems and needs.

7 Represents 0.75 percent of the three percent of the export value of any diamond officially exported from the territory of Sierra Leone.

8 This is a fund that was accumulated since colonial rule by the British government in return for the services provided by Sierra Leoneans working then for the city council. This fund is now called the development fund after the Freetown City Council started paying National Social Security and Insurant Trust (NaSSIT) benefit for its workers.

9 Estimation of figures for the revenue sources are found in Annex 1.

10 Estimation of the actual cost of collecting the key revenue sources and the potential of these revenue sources that directly impact on informal sector is found in Annexes 2 and 3 and explanatory notes on the key assumptions are found in Annex 5.

11 Excludes the SLL 7.16 billion transferred to FCC from the Crown Agent Account in FY 2008.

Local Taxation of Informal Economies in Ukraine

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Research conducted as part of the Policy Fellowship Program 2008–09
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Table of Contents

EXECUTIVE SUMMARY

This study on the local taxation of the informal sector in Ukraine provides a number of effective solutions to the scarcity of own revenue sources of local governments and their low ability to increase revenues from taxes and duties because of the high share of the informal sector in the Ukrainian economy. Potentially significant revenues could be received from the informal sector through personal income tax (PIT) and local taxes and duties. Being a minor revenue source, local taxes and duties are still not under extensive discussion among academics and fiscal practitioners in Ukraine, who mainly concentrate on state fiscal assistance and shared revenues. Another problematic issue regarding the local taxation of the informal economy is the absence of comprehensive property taxation. Increasing the local taxation of the informal sector is a useful instrument for raising local revenues, and thus fiscal autonomy, in order to make local fiscal management more effective. It is especially important for the small communities in rural areas whose needs traditionally are skipped by "big" fiscal policy.

Local governments (LGs) in Ukraine operate under little fiscal discretion and suffer from a scarcity of own financial resources, which is very typical of transition economies (Davey 2002, Horváth 2000, and Sevic 2006). Economies in transition like Ukraine's deliver a very clear example about how the revenue system characteristic of the command economy transforms into one that is consistent with the market economy and decentralized decision-making. Indeed, the unfavorable financial condition of local governments in Ukraine is more aggravated by the significant share of the informal sector in the country, which causes great losses of potential revenues for local budgets. According to the MEU[1] in 2007, its volume was 39 percent of official GDP. The peak was back in 1997, when it was 65.8 percent of GDP. The issue of bringing the unofficial economy out of the shadows becomes extremely important in light of the changes to tax legislation that came into effect in 2004. The expectation was that ensuing budget losses would largely be compensated for by business and individual incomes coming out of the shadows. As it turns out, lowering tax rates in this situation is a necessary but insufficient condition.

The base and the benchmark for this paper is a profound analysis of the current system of local taxes and duties in order to examine the current situation with revenues of local governments in Ukraine. Thus, two major goals of the study were:

- to assess the local government fiscal losses of the potential revenues because of informal sector; and
- to find out what has been done already and what could be done in order to increase the potential of the most important local taxes and duties.

These questions were studied based on nationwide statistics of public sector finance as submitted by the Ukrainian Ministry of Finance and the data on local revenues of three selected local governments within the Vinnitsa Region for the last five years: Khmilnyk (town of *oblast* significance), Illintsi (town of *rayon* significance), and Vendychany (village).

In additions, interviews, surveys, and focus group discussions were carried out with key officials of both central and local governments and representatives of the local business communities. In particular, in-depth interviews with 100 taxpayers were conducted through the taxpayers associations of the Vynnytsa region (50 respondents) and Kyiv (30 taxpayers), as well as association of small traders in Khmilnyk (20 small entrepreneurs).

A significant share of the Ukrainian population has been to some extent involved in informal activities: both formal and informal sectors. Besides the unfairness of Ukrainian tax system, there are at least four additional reasons for the strength of the informal economy in Ukraine (Joshi and Ayee 2002 and 2008, Kallay 2003): a low level of economic development; non-transparent and frequently-changed legislation; administrative inefficiency (problems of tax supervision and collection); behavior problems (taxpayer psychology, level of tax ethics).

Among the participants of informal sector in Ukraine we can distinguish:

- subjects of illegal economy that accumulated considerable capital and do not have incentives to operate in the official sector of economy;
- officially registered businessmen, who prefer to operate (at least in part) outside the scope of current legislation, aiming to and thus increaseing their profits;
- common citizens who are forced to top up their own income because of the low level of official earnings;
- public enterprise management taking advantage of the uncontrolled utilization of state property;
- local administrators who have received gains from corrupt activities.

The presence of a vast informal sector causes a number of serious problems, in particular (Joshi and Ayee 2008, Kallay 2003): a deterioration of the tax base; injustices in taxation and unfair competition; constraints to growth of national and regional economy; channels for the gradual legalization of openly criminal money; and an ineffective allocation of resources.

At the local level the consequences of informal sector existence are: a low level of social security; low quality of public services; underdeveloped infrastructure; widespread bribery; and problems with implementing local economic policy.

The structure of informal employment remained stable in 2001–2007 (Table 5.1). The majority of informal employment was in agriculture, including subsistence agriculture.

Table 5.1
Employment in the Informal Sector of the Economy by Types of Economic Activity, Percent

	2001	2002	2003	2004	2005	2006	2007
	including (% of total)						
Agriculture, hunting, and fishing	71.1	73.2	74.4	73.1	70.2	72.0	71.6
Construction	4.7	4.4	4.7	5.9	6.1	6.9	7.7
Trade, repair, hotels, and restaurants	15.9	15.2	13.8	13.7	15.0	12.8	11.8
Transport and communication	1.4	1.7	1.6	1.5	1.6	1.4	1.2
Other types of economic activity	6.9	5.5	5.5	5.8	7.1	6.9	7.7

Source: SCSU (2007).

Among other sectors, trade, repair, hotels and restaurants, and construction also have attracted a large number of informal employees, but with a noticeable reduction of the informal employment in the services (trade, repair, hotels and restaurants) and a growth in construction. The latter could be explained by recent construction boom in the country, attracting a lot of temporary workers without formal registration of their employment in the State Employment Office (SEO). One distinctive feature of the country's informal sector is a segment of people, so-called "workers on the squares" (*Maydans*), who are actually paid for their demonstrations of support for or protests against the government or leading political parties.

For the purpose of this study, three settlements in the Vinnitsa Region were chosen: Khmilnyk (city of *oblast* significance), Illintsi (town of *rayon* significance), and Vendychany (village). They are representative samples of the typical local governments of Ukraine. Besides, these three local governments reflect the three-level budget system of Ukraine. The informal sector of two towns and the village have many similar features with other local governments in Ukraine.

Local administration in Ukraine is regulated by a set of national acts, comprising the Budget Code (2001), the Law on Local Self-government (1997), and the Law on Local State Administration (1999). As in many other transitional countries, some secondary legal acts provide a significant input into the legal environment within which local governments act, especially annual budget laws and regulations of the Ukrainian Cabinet of Ministers (Decree of the Cabinet of Ministers of Ukraine 1993).

According to the Budget Code of Ukraine, some revenue sources are assigned to local governments for fulfillment of their own responsibilities and delegated responsibilities separately. So-called own revenue sources are designated to cover expenditures on own responsibilities completely. Revenues and expenditures on delegated responsibilities are estimated by the Ministry of Finance. Of course, LGs are free to collect and spend bigger amounts; the purpose of the Ministry of Finance calculations is to define the amounts of transfers to cover the gap between estimated revenues assigned to delegated responsibilities and estimated expenditures on delegated responsibilities.

Thus, the local governments are highly dependent from the state in all aspects: their accounts could be held only in the state treasury, not in commercial banks; on the regional and district levels, the state administration runs the budgets and public service delivery.

The total local revenues as a percentage of the consolidated budget, excluding inter-budgetary transfers, during 1992–2007 showed a consistent trend towards reduction. They were virtually reduced by half, from 46.6 up to 26.5 percent. During this period, total local budget revenues as percentage of GDP also dropped, albeit less markedly (from 17.9 to 15.1 per cent).

There are only a few duties that could lend local governments some capacity in revenue raising activities, thus decreasing the informal sector share. To these belong local taxes (the list set by legislation includes 16 duties of different types, all with quite limited possibility of setting tax rates and the unified small business tax (UT); these two in sum deliver barely 2.2 percent of total revenues for aggregate subnational sectors in 2007. Besides, relative proceeds from local taxes and duties (as proportion in total proceeds, transfers excluded) have shown a diminishing long-term trend.

The competence of the local governments in levying local taxes is formally quite broad: imposing local taxes and duties, granting tax credits, reduced rates and privileges to the payers to the local budgets. But the real discretion in this field is very limited, since the list of levies granted to sub-ational governments, the tax bases, and the marginal tax rates are determined centrally. It must be said that subnational governments do not have direct authority in administering their own taxes because the most important levies are collected and administered by the local offices of the State Tax Administration.

A more detailed analysis of three chosen local budgets enable some specific conclusions with respect to revenue composition in cities of *oblast* significance, cities of *rayon* significance, and villages.

Table 5.2
Structure of Local Budget Revenues in Khmilnyk (2004–2008)

Type of revenue source	2004		2005		2006		2007		2008	
	Thd UAH	Share %	Thd UAH	Share %	Thd UAH	Share %	Thd UAH	Share %	Thd UAH	Share %
Tax revenues (1)	**7,321**	**59.6**	**8,664**	**52.7**	**10,230**	**47.4**	**14,621**	**48.5**	**18,730**	**46.3**
Personal income tax	4,459	37.7	5,700	35.8	6,798	32.4	10,148	34.4	13,219	33.2
Profit tax on the enterprises owned by municipalities	68	0.6	44	0.3	45	0.2	343	1.2	113	0.3
Land fee	979	8.3	883	5.5	985	4.7	1,163	3.9	2,181	5.5
Unified tax for the small business	566	4.8	675	4.2	762	3.6	1,095	3.7	1,217	3.1
Tax on the owners of vehicles	310	2.6	382	2.4	533	2.5	653	2.2	692	1.7
Fee for the licenses on entrepreneurial activity	20	0.2	34	0.2	35	0.2	34	0.1	34	0.1
Fee for the trade patent	181	1.5	187	1.2	295	1.4	259	0.9	326	0.8
Local own taxes and fees	301	2.5	326	2.0	310	1.5	357	1.2	369	0.9
State duty	162	1.4	146	0.9	181	0.9	249	0.8	277	0.7
Nontax revenues and capital gains (2)	**86**	**0.7**	**294**	**1.8**	**419**	**2.0**	**552**	**1.9**	**1,378**	**3.5**
Targeted funds (3)	**17**	**0.1**	**23**	**0.1**	**22**	**0.1**	**106**	**0.4**	**179**	**0.5**
Subtotal: Local Revenues without transfers (1+2+3)	**7,423**	**60.4**	**8,981**	**54.7**	**10,671**	**49.5**	**15,279**	**50.7**	**20,287**	**50.2**
Official Transfers: Total	6,626	39.6	7,209	45.3	10,596	50.5	14,533	49.3	19,839	49.8
Total Revenues	**4,722**	**100.0**	**16,191**	**100.0**	**21,268**	**100.0**	**29,812**	**100.0**	**40,126**	**100.0**

Source: Financial Department of Vinnitsa state regional administration.

As shown in the Table 5.2, budget revenues in Khmilnyk (town of *oblast* significance in Vinnitsa Region) have the following characteristics:

- substantial decrease in the share of local revenues excluding transfers in total revenues (from 60.4 percent in 2004 to 50.2 percent in 2005); steep growth in shares of nontax revenues and capital gains;

- major role of PIT as a source of taxation with slight reduction of its share in total revenues during 2004–2008;
- reduction in fiscal role of local taxes, tax on the owners of vehicles, unified tax (UT);
- vigorous growth in 2008 (both in nominal and relative terms) of the revenues related to land resources, including both tax revenues (land fee) and nontax revenues (receipts from land sale and rent payments on municipal property) as a result of strengthening the monitoring procedures and the introduction of a penalty system on the part of local authorities during 2008. Thus, in particular, the land fee receipts doubled and receipts from land sales tripled as compared with the 2007 reduction of the real growth rate of the local taxes and fees in 2006 and 2008.

According to the Table 5.3, the conclusions regarding the structural changes in the budget revenues of Illintsi (town of *rayon* significance) are the following:

- the share of local own revenues in total revenues were gradually reducing during 2004–2007 (by 10 percentage points), but went back to the level of 2004 in 2008 due to nontax revenues;
- in contrast to the Khmilnik and Vendychany budgets, tax revenues in Illintsi remained the main revenue source for its budget despite their diminishing share trend within the analyzed period;
- the increase in fiscal role of nontax revenues and capital gains (especially, in 2008) correlated more with the reduction of official transfers share than with tax revenues share. Besides, nontax revenues were increasing faster during the observed period in nominal and real terms as compared to the other mentioned sources;
- PIT share grew from 32.6 to 46.6 percent (despite the tax rate cut from 15 to 13 percent in 2007), providing the largest receipts to the budget.

As for Khmilnyk, there were reductions in the fiscal role of local taxes, the motor vehicle tax and the unified tax for small businesses, due to the lower annual growth rates as compared to the general revenue trend. Thus, during the analyzed period the share of local taxes reduced by a factor of three, and the unified tax for small businesses—by a factor of 1.7.

Table 5.3
Structure of Local Budget Revenues in Illintsi (2004–2008)

Type of revenue source	2004		2005		2006		2007		2008	
	Thd UAH	Share %	Thd UAH	Share %	Thd UAH	Share %	Thd UAH	Share %	Thd UAH	Share %
Tax revenues	**1,345**	**81.9**	**1,808**	**54.3**	**2,346**	**65.3**	**3,048**	**60.5**	**4,385**	**73.7**
Personal income tax	536	32.6	756	22.7	1,260	35.1	2,058	40.9	2,775	46.6
Profit tax on the enterprises owned by municipalities	0	0.0	0	0.0	0	0.0	35	0.7	17	0.3
Tax on the owners of vehicles	90	5.5	158	4.7	176	4.9	193	3.8	245	4.1
Land fee	200	12.2	205	6.1	176	4.9	104	2.1	333	5.6
Local own taxes and fees	88	5.4	108	3.2	95	2.6	97	1.9	119	2.0
Fixed agricultural tax	6	0.4	13	0.4	38	1.1	17	0.3	16	0.3
Unified tax for the small business	308	18.7	442	13.3	513	14.3	473	9.4	724	12.2
State duty	117	7.1	126	3.8	88	2.4	70	1.4	157	2.6
Fee for the licenses on entrepreneurial activity	5	0.3	4	0.1	4	0.1	4	0.1	11	0.2
Fee for the trade patent	33	2.0	39	1.2	79	2.2	94	1.9	114	1.9
Nontax revenues and capital gains:	**70**	**4.2**	**248**	**7.5**	**431**	**12.0**	**550**	**10.9**	**616**	**10.4**
Targeted funds	**2.63**	**0.2**	**184**	**5.5**	**62**	**1.7**	**261**	**5.2**	**8**	**0.1**
Subtotal: Local Revenues without transfers	**1,417**	**86.3**	**2,240**	**67.3**	**2,838**	**79.0**	**3,858**	**76.6**	**5,010**	**84.2**
Official Transfers: Total	226	13.8	1,089	32.7	756	21.0	1,178	23.4	940	15.8
Total Revenues	**1,643**	**100.0**	**3,328**	**100.0**	**3,594**	**100.0**	**5,037**	**100.0**	**5,950**	**100.0**

Source: Financial Department of Vinnitsa regional administration.

With respect to the budget revenues of Vendychany (Table 5.4) the following conclusions can be formulated:

- official transfers remained the main source of the village budget (in compliance with Budget Code of Ukraine) during the analyzed period, while the share of total revenues without transfers in total revenues substantially decreased;
- the share of the main tax revenue source, namely PIT, was relatively stable;

- considerable reduction in revenue share of local taxes and duties (by ten times from 2.0 to 0.2 percent), tax on the owners of vehicles (by three times from 4.0 to 1.3 percent), land fee (by two times from 7.3 to 3.3 percent). At the same time, in nominal terms these types of revenues were gradually growing except for local taxes and duties, which receipts dropped by almost tree times during 2004–2008 (from UAH 16,000 to 5,000);
- strengthening in the fiscal role of revenues from capital gains and nontax revenues (the same as for two previous local governments).

Table 5.4

Structure of Local Budget Revenues in Vendychany (2004–2008)

Type of revenue source	2004		2005		2006		2007		2008	
	Thd UAH	Share %	Thd UAH	Share %	Thd UAH	Share %	Thd UAH	Share %	Thd UAH	Share %
Tax revenues	**241**	**27.1**	**196**	**12.9**	**200.4**	**10.6**	**277**	**12.7**	**415**	**12.7**
Personal income tax	81	7.0	46	4.3	73.5	4.1	126	5.8	182	5.6
Profit tax on the enterprises owned by municipalities	1	0.0	1	0.0	0.5	0.1	1	0.0	0	0.0
Tax on the owners of vehicles	25	4.0	25	0.9	15.6	0.9	26	1.3	40	1.3
Land fee	86	7.3	48	3.3	38.1	2.0	45	2.1	106	3.3
Fee for the licenses on entrepreneurial activity	0	1.0	7	0.4	4.0	0.3	2	0.1	2	0.0
Fee for the trade patent	10	1.2	12	0.7	10.6	0.5	11	0.5	12	0.3
Local own taxes and fees	16	2.0	12	0.6	10.1	0.5	5	0.2	5	0.2
Fixed agricultural tax	4	0.5	4	0.3	6.0	0.3	5	0.2	5	0.1
Unified tax for the small business	14	2.8	36	2.0	35.0	1.8	53	2.3	60	1.8
State duty	5	1.2	5	0.3	7.0	0.2	4	0.2	2	0.1
Nontax revenues and capital gains:	**144**	**0.7**	**153**	**3.4**	**128.0**	**2.2**	**68**	**0.6**	**121**	**2.9**
Targeted funds	**1**	**0.5**	**4**	**0.1**	**2.2**	**0.1**	**5**	**0.2**	**80**	**2.1**

Type of revenue source	2004		2005		2006		2007		2008	
	Thd UAH	Share %	Thd UAH	Share %	Thd UAH	Share %	Thd UAH	Share %	Thd UAH	Share %
Subtotal: Local Revenues without transfers	386	28.3	352	16.4	330.7	12.9	350	13.5	616	17.6
Official Transfers: Total	773	71.7	1,335	83.6	1,630.6	87.1	2,156	86.5	3,021	82.4
Total Revenues	**1,159**	**100.0**	**1,687**	**100.0**	**1,961.3**	**100.0**	**2,506**	**100.0**	**3,637**	**100.0**

Source: Financial Department of Vinnitsa regional administration.

The strikingly low portion of local taxes in local government coffers relates to the fact that the local governments do not have effective stimuli to exploit this source of revenues because of its insignificant role.

Table 5.5
Structure of Local Taxes and Duties in 2008 in Three Local Governments

Type of local revenue source	Khmilnyk		Illintsi		Vendychany	
	Thd UAH	Share, %	Thd UAH	Share, %	Thd UAH	Share, %
Advertisement tax	1.1	0.3	0.2	0.2	0.0	0.0
Communal tax	97.3	26.4	36.4	30.6	3.5	64.9
Vehicle parking fee	3.9	1.1	0.0	0.0	0.0	0.0
Marketplace fee	229.2	62.1	76.5	64.4	1.7	30.8
Fees for permission to lease a private apartment	0.0	0.0	0.2	0.1	0.0	0.0
Resort duty	30.3	8.2	0.0	0.0	0.0	0.0
Local sign usage tax	0.5	0.1	0.0	0.0	0.0	0.0
Local auction and lottery fees	0.0	0.0	0.2	0.2	0.0	0.0
Duty for the issuance of a permit to locate vending and service facilities	6.6	1.8	5.4	4.6	0.2	4.3
Total local taxes and fees	368.9	100.0	118.8	100.0	5.4	100.0

Source: Financial Department of Vinnitsa regional administration.

Looking at Table 5.5, the most significant local taxes and duties in all three settlements are communal tax, marketplace fees, and duty for the issuance of a permit to locate vending and service facilities. Besides, the distinctive feature of Khmilnyk is fairly significant share of resort duty (8.2 percent of their total amount).

The analysis of three cases mentioned above led us to a quick conclusion regarding the rather sudden reduction in tax revenue share (comparing with nontax revenues). In particular, special attention should be paid to the fact of steady reduction in revenue share from local taxes and duties.

What are the reasons for the reduction in the fiscal role of local tax revenues?

Interviews conducted with the local officials in these three local governments and Kiev resulted in the identification of at least four main reasons: out-of-date and contradictive legislation; a lack of local taxes and duties (in the list), with high elasticity with regard to local economic development (Zaichikova 2006 and Ivanenko 2005); a lack of incentives for local governments to raise revenues from local sources, as increasingly higher percentage of their revenues comes from delegated (ceded) revenues and transfers (Goncharenko 2005); and an increase in the informal sector on the local level.

We will pay attention on the last one, which is a core issue for our research, starting with the analysis of the major local revenue source, namely, PIT.

The data on the PIT receipts for three local budgets provethat they are the foundation of local budgets, determining primarily the funds available for healthcare and education. This explains why the legalization of individual incomes and incentives to legitimize incomes must be a state policy priority to provide additional financial resources for local budgets in Ukraine.

Most of the state policy measures being used to reduce the share of informal incomes in Ukraine involved decreasing tax rates and making tax administration more effective. Much less has been done to improve the quality of public services and make tax legislation more understandable, clear, and predictable (Lavriv 2003 and Pavlyuk 2006).

The system for taxing individual incomes was a subject of the most radical changes, with a flat 13-percent tax rate replacing the progressive tax system in 2004. While this step led to a significant reduction in the tax burden, especially for individuals with higher than average incomes, this step has proved insufficient, failing to solve the problem of Pension Fund contributions, which constitute the lion's share of all payroll deductions and are the main reason why employers prefer to pay wages "in white envelopes."

In 2001, the president signed a decree on measures to bring the economy out of the shadows, and a simplified tax system had already been introduced for small businesses in 1999. A lump-sum tax replaced a variety of taxes and mandatory social contributions for those businesses which were eligible. In general, these measures have influenced the process of bringing the economy out of the shadows in a positive way. According to estimates by Ministry of Economy, the share of the shadow economy reached its peak in 1998 and has been slowly shrinking ever since. Still, a look at the continuing impact of the informal economy shows a host of unaddressed issues:

- **Tax rates and social contributions.** High Pension Fund contribution rates make it almost impossible for many companies to work profitably if they pay all the formal deductions, leading them to conceal some part of their payrolls.
- **Incentives for staying in the formal economy.** A system of incentives is the least developed tool for bringing incomes out of the shadows, while a host of features in the social security and pension systems provoke individuals and businesses alike to move into the informal sector. For an average Ukrainian, the taxes and contributions paid do not correlate to the availability of healthcare services, since they are ostensibly provided to everyone.
- **Penalties for tax evasion and oversight over commercial activities.** Legislation provides for heavy fines for evading or delaying taxes, but the impunity of high-profile taxpayers who evade payment has a negative impact on the public consciousness (Fjeldstad 2001 and Fejeldstad and Raker 2003).

Taking the current problems in each of these areas into account, it can be argued that positive trends leading the economy from its dependence on the informal sector are unstable and new measures are needed to maintain and strengthen them.

The small business tax or unified tax (UT) was introduced by a presidential decree in 1998 in order to make way for the legalization of small businesses that had up till that point, a signficiant motivation to escape taxation through non-registration under the common tax regime. Thus, the small businesses in most areas of economic activity[2] gained the right to switching to paying the small business tax in one lump sum, instead of paying a host of taxes like VAT, enterprise profit tax, PIT, land tax, trade patent fee, trade permit fee, and contributions to social security and pension funds, in addition to some local taxes and duties.

Actually, Ukraine uses UT of two types: (a) a lump-sum rate UT as concerns natural persons and (b) a fixed proportional rate UT as concerns legal persons. So natural persons with an annual turnover up to UAH 500,000 and up to 10 staff could be taxed by a lump sum ranging from UAH 20 to 200 per month; legal persons with a turnover up to UAH 1,000,000 and up to 50 hired personal could choose to pay 6 per cent tax in turnover in case they decide to pay VAT, or 10 percent in the opposite case.

As concerns UT for legal persons, there is actually no discretion for local governments to vary tax rates because the tax rate schedule is set by the national legislation and a rate can be freely chosen by the taxpayer according to his or her own benefit calculus. As concerns UT for natural persons (UTNP), there is some room for local government's tax rate discretion because the legislation sets only the tax rate margins (from 20–200 UAH monthly) that allows the local governments to decide upon setting tax rates for different economic activities within these margins.

Evaluating Ukrainian UTNP one must admit that it looks quite attractive for small businesses. The number of small businesses registered as UTNP payers in Ukraine has increased in the period 1999–2008 from 66,000 to nearly a million.

As demonstrated by the statistical data of three local governments, the rates of this tax for individuals are far from the maximum (which is UAH 200 a month, disregarding the status of the paid employees). For instance, the rate of UTNP for Khmilnyk is 40 percent of the maximum level, and in Illintsi and Vendychany—30 and 25 percent, correspondingly. It demonstrates that local governments are not really interested in revenues from this tax as the total revenues from this tax are shared between the central and the local budgets and the local budgets, in fact, receive only a token part of the total revenues (43 percent for UTNP).

Local tax officers and fiscal administrators interviewed suggest that the UTNP is often being used for tax evasion: the engagement of paid employees without making formal labor contracts with them; evasion from payment of PIT, some local taxes, and payroll taxes by registering employees as business entities, which are the payers of UT. The main possibility to evade UT is not registering as a small entrepreneur.

Interviews were conducted with 100 taxpayers,[3] mainly representatives of small- and medium-size businesses in the Vynnytsa region and the city of Kiev. Their answers helped *to establish what taxpayers think when they pay taxes; to determine the main reasons for tax evasion; and to evaluate the potential level of the main revenue sources of their budgets.*

For the first question, "How do you feel when you pay taxes?" the following answers were obtained and are listed in Table 5.6.

Table 5.6

How Do You Feel When You Pay Taxes?

The money spent on taxes is returned to you and your family by local budget expenditures	3.3%
You are part of the financial power of the state	3.3%
You support those who need the money more than you	8.9%
Officials take money that you honestly earn	28.0%
Anyway, all this money is plundered by officials	36.0%
Taxpayers' money is not plundered, but is not distributed as you wish	17.6%
Other	2.4%
Hard to say	0.5%

The majority of the respondents (64 percent) relate their negative perception of tax paying with dishonesty of the officials. Such mistrust is formulated as either "officials take the money that we honestly earn" (28 percent of all participants) or "all this money is plundered by officials" (36 percent). Almost 18 percent of all taxpayers do not consider that money out of taxes is plundered by officials, but rather think that the collected resources are distributed ineffectively.

Regarding the second issue, namely, *the main reasons for tax evasion*, the following answers were received: excessive tax burden; fuzzy tax legislation; excessive number of official and non-official levies; imperfection of tax administration; non-transparent mechanism of revenues distribution between different levels of budget system.

The taxpayers' estimates of the amount of tax potential that is actually paid is presented in the Table 5.7 (where 100 percent means that the tax or fee is fully paid without evasions).

Table 5.7

Respondents' Estimates of the Amount of Tax Potential That Is Actually Paid, According to Type of Tax or Fee, in Percent

Revenue source	Percent of potential proceeds (estimated average level)
Personal income tax	40
Tax on the owners of vehicles	90
Unified tax for small businesses	80
Land fee	85
Rent on municipal property	40
Fee for the licenses on entrepreneurial activity	85
Fee for the trade patent	87
Own local taxes and fees	60
Fee for the use of natural resources	45

Source: Data collection, 2009.

Thus, PIT, rent on municipal property, and local taxes (fees) have the lowest potential level, while the estimation of the tax on the owners of motor vehicles is quite close to the target. The low percentage rate for PIT is primarily explained by the enormously high payroll tax, where as low receipts from municipal property rent are related to practices of unofficial payments to local authorities and intentionally downgraded tax assessment of real property. The small tax potential of local taxes and fees resulted from lack of incentives for local governments to raise revenues from local sources.

The estimates of the share of unregistered retail trade[4] in Ukraine constituted approximately 40 percent of the total volume of retail trade in 2006–2007, which is mostly concentrated in the food sector. In particular, over 58 percent of meat retail is currently informal, which has reduced over the past three years by seven percentage points. Besides, unregistered street markets remain the second most favorite place for food purchases by consumers after supermarkets (22 percent of all consumers buy goods on the street).

It correlates with the respective figures at the local level. Thus, due to the estimate of Khmilnyk local tax administration, the share of unregistered retail trade constituted nearly 43 percent in 2008. The majority of street vendors sell fresh vegetables and fruit, fresh meat and milk, and cigarettes (Table 5.8). Street vendors are mainly located near the official municipal markets, shopping areas, other public places (educational centers, sanatoriums, and hospitals) as well as near the roads, motorways and bus stations. Consumers of such goods are low- and middle-income households and pensioners.

According to the data received from the interviews carried out with 80 street venders in Khmilnyk almost 82 percent of respondents are paying unregistered fees to the representatives of local authorities (police, tax inspectors, sanitary inspectors).[5]

Table 5.8

The Results of the Survey on Unregistered Street Trade in Khmilnyk

No.	Variables	Received data
1.	Types of selling goods	▪ Vegetables and fruit 45% ▪ Meat and milk 35% ▪ Cigarettes 20%
2.	Ability to change trading location	▪ Fixed 35% ▪ Mobile 65%
3.	Recipients of unregistered payments from street vendors	▪ representatives of local power (police, tax inspectors, sanitary inspectors) 82% ▪ non-officials 0% ▪ no receiver (e.g., vendors do not pay anything to anybody) 18%
4.	Unregistered daily payments	▪ UAH 10 45% ▪ UAH 20 35% ▪ UAH 35 20%
5.	Average daily incomes	▪ UAH 50–100 26% ▪ UAH 100–150 46% ▪ UAH 150–300 17% ▪ More than UAH 300 11%
6.	Main reasons for rejection to pay official taxes and fees	▪ Excessive tax burden of the official payments 67% of all respondents ▪ Unclear tax laws 32% of all respondents ▪ Large number of taxes 34% of all respondents ▪ Uncertainty of appropriate use of the official payments 96% of all respondents ▪ Habituation effect 16% of all respondents

No.	Variables	Received data
7.	Perception towards the official tax payments	▪ More than 50% goes to local budget 11% ▪ 50% goes to local budget 29% ▪ Less than 50% goes to local budget 47% ▪ Nothing goes to local budget 13%

Source: Data collection, 2009.

Most of them are quite mobile and can easily move to another location in case of unexpected raids (in order not to pay penalties for the trade in the prohibited zone or without licenses). As 46 percent of all respondents earn on the average UAH 100–150, their monthly gross income in the informal sector is three times higher than the average pension and twice as high compared to the average salary in Ukraine.

Unregistered daily payments by street vendors to the representatives of local power are fixed and differ depending on the type of goods for sale (for vegetables, UAH 10; citrus, UAH 20; meat, UAH 35). Thus, vendors' costs for unregistered fees do not exceed 15 percent of their gross income, which is highly profitable for them. Many vendors are also receiving information from policemen (to whom they pay) about possible raids.

The respondents were also asked about their perception towards the official tax payments. Eighty-six percent of the vendors do not believe that more than half of official taxes and duties go to the local budget. Among the main reasons for not wanting to pay official levies are the uncertainty of the appropriate use of the official payments (96 percent of all vendors) and the excessive tax burden of the official payments (67 percent).

The strict administrative measures enforced by the local administration are not systematic and have not brought about any significant results in reducing informal trade in Khmilnyk. Therefore, it might be more efficient to create favorable conditions for their trade, for instance, the creation of additional marketplaces or social markets, as well as the introduction of regular trade fairs in the city. It will reduce the informal sector and increase the quality of the goods sold.

Given the reasons behind the emergence of a vast informal sector, it is possible to name three areas where changes could reduce the ratio of informal incomes at the local level: *the tax system, incentives for working in the formal economy, penalties for tax evasion, and better oversight over commercial activities*.

Correspondingly, the main strategy we have chosen involves shifting the main emphasis to improving the quality of public services while further reducing the tax burden, simplifying tax legislation, and regulating commercial activity (Bahl and Bird 2008). This strategy is based on the assumption that the main reason why previous efforts to bring the economy out of the shadows have not yielded the desired results is the inadequate attention paid to creating a system where working in the formal economy offers more advantages than working in the margins. The main shortcoming of this strategy is that it is not a quick fix and the first stages of implementation will require additional resources. Any anticipated growth in local budget revenues is likely to take some time, but the possibility of obtaining sustainable results makes this strategy more attractive. In this complex, we have singled out measures that are aimed at (Pikhotska 2003, Slukhai 2006, and Bird 2000): *increasing trust in government; raising the quality of public services; improving tax administration; stronger penalities for tax evasion; more active administrative and criminal prosecution for those individuals who collect illegal payments and "protect" street vendors.*

The interviews conducted in the course of this study show that the vast majority of Ukrainians support a reduction in payroll deductions and see this measure as necessary to bring their personal incomes out of the shadows. At the same time, raising the retirement age is an extremely unpopular step. This is because the risk of losing a job is quite high for a worker who is close to the retirement age, which outweighs the benefit of having much higher income for a longer period of time.

We will discuss some of the measures below in more detail.

Better administration of the unified small business tax. It is obvious that a significant increase of UT receipts would be achieved only in case when the local governments have higher interest in their own revenue growth; it requires to change a status of some formally local revenue sources that, in fact, are heavily regulated by the state to entirely own revenues. In addition, due to the surveys, entrepreneurs consider UT to be one of the least cumbersome taxes, which provides good prospects for growth in employment and income of paid employees (Chunykha 2005). So, this tax shall be fully assigned to the local governments. The implementation of these proposals is the only way to remove such an inconsistency when moving to a simplified taxation system, whereby the taxpayers became exempt from payment of both the taxes treated as national ones and the taxes treated by the Budget Code of Ukraine as own revenues. To the latter belong, in particular, the land registration fee, and some local taxes and duties. The unified tax on legal persons could remain in the first basket since the local governments could not affect its rate; that being said, the list of taxes/duties from which a UT payer is exempted, shall be limited to the earnings which belong to it.

There could be a question, whether the local governments have sufficient administrative capacity to administer the UTNP. But since the structure of such a tax is very simple (lump sums depending on types of activity), there is little problem with its administration. The existing fiscal departments of local governments could easily take this function.

A differentiation of UTNP rates by officially approved business activity would also very helpful for raising UT proceeds. This will make it possible, first, to encourage local governments to setting tax rates at a more or less adequate level for some profit-bringing activities, and second, to reduce its likely distorting impact on taxpayer behavior (with respect to selecting the place of registration, in particular). In our view, such an approach should be combined with the differentiation of the tax rates according to earnings as suggested by some economists (Ljutyi and Romanyuk 2007), which would produce fewer incentives to evade tax payments.

Better administration of land payments. Revenues from municipal land use and sales currently deliver about 10 percent of Ukrainian local government revenues. There is a trend of increasing the land sale tax's share in this revenue type: according to data of the Ministry of Finance, in 2001, it brought 10 percent of revenue stemming from municipal land, but in 2007 it was 40 percent; in large cities like Kiev, this figure reached a value of 70 percent. Despite such a relatively large value, there are a lot of possibilities to make land revenue sources much more important. It especially concerns land sale.

The fact is that only insignificant portion of municipal land in Ukraine has been alienated through competitive bidding procedures: most land plots (far more than 95 percent) were given away on a "free" basis. The open land auctions have been organized mostly in the large cities, but never in small cities and villages. A bias to such a non-transparent procedure of allotting the valuable land parcels clearly signals the prevalence of private interests over public ones. Receiving land for free is obviously connected with high-scale bribery when heads of rural councils may be offered USD millions for extremely favorable council decisions.

All these facts demonstrate that the mere strict limitation to the practice of allotting land for free in conjunction with introducing competitive land tenders would greatly increase local revenues. But in order to be introduced, real, effective public control is needed and nearly impossible without greater transparency and accountability on the part of local governments.

Opti*mization of a current local revenue list and exemptions.* The trend in revenue composition (basing on three analyzed local governments) calls for reform because the current composition cannot insure sufficient revenue adequacy, even for funding delegated functions. That is why it is very important to find how to expand the local revenue base while also decreasing the informal sector (Bird and Wallace 2003). The most viable candidates to be included in local levies are taxes on land and property, and the motor vehicle tax. The tax on land is still a national levy ceded to local governments; the motor vehicle tax is a national levy assigned to subnational budgets. By assigning these taxes fully to the local governments, the center could retain control by defining the tax basis and marginal rates of taxation in legislation.

In general, the following five options have been considered in order to change the approach towards the local taxation (see Table 5.9) (Lavriv 2003 and Tarangul 2002):

Table 5.9
Analysis of the Policy Options

Policy option	Consequences
1. Gradual transferring of important revenue types from the central government to the local governments.	This will provide a setting where local administrators must act responsibly when collecting own revenue and individuals will start demanding reports about spending.
2. Shortening of the list of inefficient local taxes and duties (like dog tax, trotting matches duty, use of local symbol duty, etc., which in total, yield only small percentage of local taxation proceeds, but need great administrative efforts).	This step will make tax administration more concentrated on important revenue sources, and thus improve its efficiency.
3. Improvement of the tax structure for those local taxes that remain on the list.	Abandoning tax rates bound to minimal nontaxable individual income and setting them as a lump sum or as a percentage of the tax base. It will ensure a higher elasticity of tax revenues, and hence, greater correspondence between the amount of revenues collected and expenditures.
4. Granting local self-government authorities the right to introduce by their decision some local duties that could bring sufficient revenue to solve some specific local problems (with the burden falling only onto the local inhabitants).	It will provide the grounds for expansion of self-taxation on settlements and city communities. Moreover, it will help to achieve the fiscal equivalence at the self-government authority level, i.e., higher correspondence between the expenditure and mobilization of revenues in a particular territory.
5. Reduction of tax evasions through increasing the punishment for truant taxpayers and those individuals who help them by using their administrative position (the officials who take unofficial payments).	This step will create higher motivation for taxpayers to obey tax legislation and thus make the tax proceeds larger.
6. Introducing local tax administrations dealing only with local taxes and duties.	Significant increase in local taxes and duties proceeds due to greater motivation for the local governments to collect the full amount of payments.

Introduction of new local taxes and duties: property tax. From many countries, one of the most effective ways to reduce the size of the informal sector and raise local budget revenues through the expansion of the local revenue base is the introduction of a property tax (Brzeski 2008, Lewis 2006, and Slukhai 2008). Such a tax facilitates greater fairness concerning wealth distribution and can reveal the hidden share of the informal sector in Ukraine.

Unlike many other transition countries, Ukraine has no explicit property taxation on either the local or the national level. Instead, there are some property quasi-taxes like the land tax, the motor vehicle tax, and the natural resource utilization levies that are assigned to the local budgets. The revenue capacity and local rate-setting discretion concerning these levies is very limited.

First, the property taxes have specific features, which make them convenient for use as local taxes: real property cannot be hidden or moved to a different territory, so the "natural" intent of economic entities to evade taxation is minimized. In addition, it is the local level where any changes, which may be made to the tax base, are easier to observe.

The second argument for use of local property taxation is reliability of such taxes. According to the worldwide experience, such taxes, compared to many other taxes, show a higher stability of revenues, as cyclical changes in the market never effect them as directly as in case of corporate profit tax, PIT, or VAT. That is why property tax is capable of assuring revenues and certain amount of financial stability for local self-government authorities even in a period of economic recession.

At the same time, this tax is associated with some problems that make its administration quite challenging. It needs well-trained staff and careful administration and it is, therefore, connected with quite high administrative costs; its sophisticated structure could generate significant space for administrative misbehavior; in the case of underdeveloped markets, it is difficult to find an appropriate tax base; and finally, it is very sensitive politically. Such a tax intervenes with the economic interests of different groups of the population, especially the richest, who are not interested in sharing their fortunes with others.

Field research performed by SufTAR (2006) in the Ivano-Frankivsk region has shown that there is some optimism concerning the first two issues. In the regions, there is some information collected concerning residential property. In urban areas, the Bureaus of Technical Inventory hold some information on the location and size of privatized homes and apartments that extends for 30 up to 80 percent of households, as well as their initial value (market price). Housing departments have complete information on all the immobile property in the location. In the rural areas, the local governments keep information on local households, their private homes, and land plots.

This data is still incomplete (especially concerning commercial property) and is stored mostly on paper. Nevertheless, even with such incomplete information, a hypothetic taxation of private homes and apartments performed at a flat rate per square meter (one-tenth of that one employed in Poland—UAH 0.1 per square meter of dwelling space *per annum* and UAH 2.9 per square meter for commercial property objects[6]) brought some promising results: in some districts this tax could yield on average up to 25 percent and even more (in some locations 70 percent!) of current revenues, excluding grants.

This demonstrates the potential of property taxation, even in such a simplified and non-onerous form (e.g., the owner of a 100 square meter flat would pay UAH 10 annually while a kilogram of beef costs UAH 40–50), could be quite an important source of local revenues and constitute some kind of local fiscal autonomy in the case were proceeds will accrue the local budget. There will be no significant administration costs associated with such a tax because the property information (including its current market value at the moment of property acquisition) is now being collected at the cost of citizens who must register their possessions; the annual tax forms could be filled in by them, too.

Even if the mode of lump-sum tax per dwelling is chosen, this will swell local budgets. The introduction of the property tax assigned to local governments will help urban and neighboring communities in the first line. The large cities of national and *oblast* significance will receive a generous source of revenues because valuable property objects are concentrated in cities and suburban localities. But the rural communities will also benefit greatly from this fiscal innovation.

Currently, several options concerning property taxation are being discussed in the parliamentary committees. There are quite serious discrepancies in the approaches of the legislators, reflecting their ideological biases. For example, drafts submitted by the left-wing politicians (representatives of the Socialist and Communist Parties) are biased, so as to make the tax into an instrument to achieve a more even distribution of wealth, while proposing a long list of exclusions from taxation for different categories of taxpayers. They also tend to assign this tax to the central government. There is some logic to this approach, but it leaves open the question of strengthening local government finance, despite the fact that both parties often use decentralization rhetoric.

Summarizing the above facts, we could argue that the introduction of the property tax in Ukraine would actually decrease the level of the informal sector, increase the level of social equality, and enhance the local revenue sources, making local governments fiscally more independent. Technically, it is possible even now, within a short period of time, to make this tax work. On the other hand, the uneven concentration of property objects would widen the gaps in terms of territory-specific fiscal endowment, which would then call for the improvement of fiscal equalization procedures now extending only over ceded revenues and delegated functions.

Consequently, the relevant legislation could be adopted within a short time span, followed by the introduction of the tax as early as 2010 (after the fall's presidential election). We opt for the simplest form of the tax (lump sum or flat rate) with some adjusting coefficients to begin. Most socially motivated exclusions must be omitted (or radically reduced) in order to make people accustomed to paying property taxes and to avoid the danger of massive fraud like registering property with a category of payers exempt from taxation (e.g., retirees, low-income individuals, or large families). After some time (three years at least), a more sophisticated approach, possibly one based on market evaluation, could be applied.

RECOMMENDATIONS

For National Authorities

- **Adoption of the Tax Code with changes in tax legislation concerning:** (a) simplification of tax collection procedures and structure; (b) elimination of inefficient local taxes and revision of exemptions; (c) reduction of payroll tax; (d) reinforcing heavier fiscal penalties for local tax evasion and bribes; (e) establishing local tax administrations subordinated to the local council and responsible for collection of its own revenues; (f) introduction of property tax.
- **Through changes in the Budget Code, to transfer some shared revenue sources** in a full amount to local budgets (primarily, tax on the owners of motor vehicles, unified and land taxes) as well as overestimated receipts, which will make local governments highly motivated to collect them in full.
- **As concerns the State Tax Administration, taking special measures on strengthening of mutual understanding and collaboration** between entrepreneurs and taxing authorities (common seminars, round tables, dissemination of information), between state taxing authorities and local governments (information on taxpayers and their contribution to the local budget).

For the Local Governments

- **Reduction of the number of tax privileges** along with deeper differentiation of local tax rates.
- **Introduction of local revenue registers (so-called "territorial passport"),** allowing local governments to plan their own revenues more precisely and to have an instrument to evaluate local tax administration performance.
- **Ensuring of civilized conditions for local small and micro business activity.** The best measure will be organizing appropriate places for small business activities (like marketplaces) under strict control of the local government.

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NOTES

1 The Ministry of Economy of Ukraine.

2 The following business activities are not eligible for simplified taxation: gambling, lotteries, currency exchange, production of excisable goods, production and selling of jewelry.

3 Between January 15 and February 25, focus group discussions and in-depth interviews were carried out with 100 taxpayers. They were organized through taxpayers' associations in the Vynnytsa Region (50 respondents) and Kiev (30 taxpayers), as well as the association of small traders in Khmilnyk (20 small business entrepreneurs). It helped to eliminate the effects of regional factors and to receive more reliable information from different groups of respondents using purposive sampling technique.

4 Unregistered means out of general or simplified taxation; marketplace duty is not paid.

5 The fieldwork was based on in-depth interviews with 80 street traders using quota sampling technique. The interviews were conducted in one area (in Khmilnik) in the four largest unregistered marketplaces ("spontaneous" markets). The respondents were chosen by quotas according to the main types of selling goods (45 percent selling vegetables and fruits, 35 percent meat and milk, 20 percent cigarettes).

6 We agree that such a difference in rates existing in Poland is economically not well motivated; the rates here are applied only to illustrate that property taxation in Ukraine does have a significant revenue potential.

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